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Rating Update: Moody's maintains Baa1 on Vermont Public Power Supply Authority's Swanton Project Bonds; Outlook is Stable

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VERMONT PUBLIC POWER SUPPLY AUTHORITY - SWANTON PEAKING FACILITY PROJECT
Joint Power/Action Agency (JPA)
VT

Opinion

NEW YORK, December 18, 2014 --Moody's Investors Service maintains Baa1 rating on Vermont Public Power Supply Authority - Swanton Project (Swanton) $21.35 million special obligation revenue bonds. The outlook is stable.

ISSUER PROFILE

The Swanton Project is a 40 MW dual-fuel peaking electric generation plant in Swanton, VT that is a special obligation project of the Vermont Public Power Supply Authority (VPPSA). The plant achieved full commercial operation in June 2010. The project maintains take-or-pay contracts with 12 project participants, of which 11 are municipal electric utilities and one is a rural electric distribution cooperative. The two turbines at Swanton are capable of operating at full capacity within 10 minutes which is a beneficial resource for electrical grid stability that the Independent System Operator of New England (ISO-NE) recognizes and compensates for.

The facility achieved a 96% combined availability factor in 2013 and generated 540 MWh, resulting in a capacity factor below 1%, which reflects the plant's peaking position along the dispatch curve. The project is mostly utilized for reserve capacity purposes in the ISO-NE forward and real time markets.

SUMMARY RATING RATIONALE

The Baa1 rating on the VPPSA - Swanton project bonds reflects the legal security of the take-or-pay power sales agreements with 11 municipal electric utilities and 1 rural electric cooperative who have an estimated Baa1 weighted average credit quality. The project participants further benefit from owning a local resource that can bid into the forward capacity and energy markets, and realize value from its ancillary services.

The rating level also considers the additional $3.5 million amortizing note obligation the project took on as a result of costs incurred during construction and start-up operations. The note added an additional $500,000 in annual debt service costs through 2017 and increases the total project cost to the participants. The rating further considers the plant's status as a peaking facility and the requirement for Vermont municipal utilities to have their rates approved by the Vermont Public Service Board (though VPPSA has unregulated rate setting authority).

OUTLOOK

The stable outlook reflects our expectation for steady operating and financial performance at the project.

WHAT COULD CHANGE THE RATING - UP

The rating is adequately positioned at the current level but could be revised upward if there is a notable improvement in the project participants' weighted average credit quality.

WHAT COULD CHANGE THE RATING - DOWN

The rating could face downward pressure if the participants' weighted average credit quality suffers material deterioration, or if there are unexpected major outages that impact financial performance.

LEGAL SECURITY

Pledged net revenues are derived from the power sales agreements with 11 municipal electric utilities and 1 rural electric cooperative according to their project entitlement shares. The bond rate covenant is sum-sufficient, and any additional bond issuance is subject to approval by the Vermont Public Service Board. The debt service reserve fund is fully cash funded and sized to meet maximum annual debt service.

STRENGTHS

* Take-or-pay power sales agreements have been legally validated in the state and are a major source of cash flow security

* The Swanton facility provides the participants with fast start reserve capacity, a highly valued market product by ISO-NE due to its ability to quickly help stabilize the New England electrical grid

* VPPSA has a track-record of consistent financial management, and maintains an active role in its participants' electric systems by assisting in rate-making and other management services

CHALLENGES

* Estimated Baa1 weighted average participant credit quality reflects weaker participant profiles securing the obligations under the power sales agreements

* Though VPPSA has unregulated rate setting authority, the Vermont Public Service Board (VPSB) regulates the Swanton participant's electric rates which could limit the scope of rate increases necessary to meet obligations under the power sales agreement

* Conversion of a $3.5 million revolving credit line into an amortizing note payable due in 2017 to accommodate cost increases during construction, increasing the overall cost of the Swanton project to the participants

* Single asset concentration

INTEREST RATE DERIVATIVES - $3.5 million notional interest rate swap with KeyBank whereby VPPSA is the fixed-rate payer. The swap was entered into as an interest rate hedge for the $3.5 million variable rate note that VPPSA entered into on behalf of the Swanton project as described above.

DETAILED CREDIT DISCUSSION

RECENT DEVELOPMENTS

The project's total revenues for 2013 were $3.4 million which was a 1.7% increase over 2012. The increase is attributed to general increases in O&M costs that were billed to project participants and possibly due to the revenue related to market credits that the VPPSA participants receive. Capacity factor increased slightly to 0.15% in 2013 which contributed to higher fuel expenses. As a result, operating income decreased by 6% in 2013 to $1.4 million.

Availability increased slightly to 96% in 2013.Maintenance and reliability upgrades are expected in the coming years and may impact future availability.

PARTICIPANT WEIGHTED AVERAGE CREDIT QUALITY ANCHORS THE PROJECT RATING

The take-or-pay contract obligation with the project participants underpins Swanton's rating and the financial health of the participants is a key credit consideration. Many of the plant's participants had seen their financial metrics deteriorate during the challenging 2008-09 period as a result of economic conditions and a general neglect for timely rate increases leading up to that point. Many Swanton participants have proactively sought to solidify their financial positions since that time by more closely monitoring their financial positions and pursuing more frequent rate increases. The estimated weighted average credit quality for all Swanton participants rests firmly in the Baa1 category.

While VPPSA is free from regulation when setting its rates, municipal electric utilities across the state are subject to rate regulation and oversight by the VPSB (unique in the municipal power sector), which we view as a weakness and potential constraint to full cost recovery. Nearly all participants have implemented at least one rate increase since 2009, and the VPSB has generally accommodated rate increase requests in full, or close to the amount requested by the respective participant. These rate increases have resulted in higher net operating revenue for each of the participants, which indirectly benefits the financial profile for the Swanton project bonds.

LIMITED PLANT DISPATCH IS TEMPERED BY THE BENEFITS OF A FULLY-OWNED ASSET THAT EARNS FORWARD CAPACITY REVENUE AND ANCILLARY SERVICES

The Swanton project adds to VPPSA's and the participants' portfolio of owned resources, particularly since most of the participants' energy needs come from contracted resources or market purchases. As a peaking plant, the facility is not anticipated to have many run hours in a given year, but its strategic value to project participants rests in its availability to run and sell its capacity into the forward and real time markets. Swanton is capable of reaching its full operating capacity within ten minutes of being called upon, and is compensated by ISO-NE for that service. It will be incumbent on VPPSA to manage the major maintenance needs of the facility in order to keep the plant's availability above the threshold to earn capacity revenue from ISO-NE. VPPSA has hired a dedicated plant operator at Swanton who will be responsible for monitoring day-to-day operation and maintenance activities. We view this development as credit positive to the plant's operational profile. Swanton's availability measured 96% in 2013 and 91% in 2012. As anticipated, the plant's capacity factor measured below 1%.

ADDITIONAL DEBT INCURRED AFTER PLANT FIRE WEAKENS CREDIT HOWEVER ALL INSURANCE CLAIMS HAVE BEEN SETTLED

As previously mentioned in prior research, a fire ignited within the unit #2 generator that damaged the generator and delayed the unit's commissioning in 2010 and costs during construction and start-up exceeded what was expected. In response to these developments, VPPSA secured credit lines to fund the project construction and startup cost overruns. Over the course of 2010, the credit lines increased to $3.65 million before being converted to a $3.5 million medium-term amortizing note due 2017. The note is secured by a pledge of revenues secured under the Swanton power sales agreements, subordinate to the 2009 Series A and B bonds. The amortizing note adds an additional $500,000 per year in debt service, which is being collected from the project participants on a monthly basis. We view the additional debt needed to satisfy the project's market commitments and unit repairs as a credit negative since it increases the total cost of the project to the participants. In May 2013, the project recovered the final $380,000 insurance settlement related to the start-up fire and the insurance claim was finalized.

STEADY FINANCIAL PERFORMANCE ALBEIT WITH NARROW COVERAGE MARGINS

Swanton's post-PILOT debt service coverage ratio, measured 1.04 times in 2013, which is comparable with the prior year as debt service obligations include total debt service from the bonds and the term loan. Insurance proceeds have not been included in Moody's post-PILOT debt service coverage calculation. We anticipate that coverage margins will measure between 1.05 and 1.15 times in the near-term, and should improve post-2017 once the term loan has been fully amortized. Overall, the project's annual debt service obligation is level through maturity at approximately $1.96 million per year, with an additional $500,000 through 2017 to cover the debt service needs on the $3.5 million term loan.

The project's unrestricted liquidity has shown steady improvement since 2010 as a result of insurance recoveries related to the unit #2 fire. The days cash on hand metric has been volatile due to operating expense increases in 2010 related to necessary repairs after the fire, followed by a decline to more steady state operating expenses in 2011. Overall, Swanton's liquidity as expressed in days cash on hand measured 223 days in 2013.

The project's liquidity helps mitigate any financial risk related to operating performance, and alleviates any potential timing mismatch between cost outlays and recovery from participants, particularly if any true-up would require a participant to file an emergency 45-day rate case. VPPSA collects monthly payments from its members based on an agreed upon budget, which includes debt service costs and a budgeted margin. The risk to this method rests in the chance that actual costs turn out to be higher than budgeted costs which would require a true-up with the participants in future billing periods. Lastly, Swanton benefits from a $109,000 reserve and contingency fund that is restricted for capital expenditures, though does provide an additional liquidity source that is not counted in days cash on hand.

VPPSA PURCHASE OF VT TRANSCO EQUITY UNITS ON MEMBERS BEHALF COULD PUT FINANCIAL PRESSURE ON PROJECT PARTICIPANTS IN AN UNLIKELY DOWNSIDE SCENARIO

As mentioned in our prior research, VPPSA has pursued a strategy to purchase VT TRANSCO LLC ownership certificates when available on behalf of its members, and have financed those purchases with a fixed-rate note that matures in 2021. The note is collateralized by a security pledge of the acquired membership units. The TRANSCO ownership certificates provide a rate of return that averages about 12.5%, which is well above the financing costs for purchasing the ownership certificates.

It is important to note that the TRANSCO ownership certificates arrangement does not directly affect the Swanton project since the purchases are undertaken within VPPSA's regular day-to-day operations, and are outside of the project's special obligation framework. However, since the Swanton participants are VPPSA members, and participate in the TRANSCO ownership certificates arrangement, there is a potential risk for the return on the ownership certificates to drop below their cost of financing. We note the slim likelihood of occurrence for such a scenario given the current spread between the certificates' return and cost of financing, though it should be noted as a risk. If the rate of return should fall below the cost of financing, VPPSA would call upon members to fund the difference in the form of higher rates for VPPSA's regular operations, thus placing financial pressure on the members which could potentially erode their credit quality (including Swanton participants) if they are unable to pass along the higher rates to retail customers in a timely fashion

The principal methodology used in this rating was US Municipal Joint Action Agencies published in October 2012. As shown below, Swanton's grid indicated rating is Baa2, one notch below the Baa1 assigned rating. The Baa1 rating considers other factors outside of the methodology, Swanton's importance to ISO-NE as a fast-start generating facility.

METHODOLOGY FACTORS:

Factor 1 - Participant Credit Quality and Cost Recovery Framework - Baa1

Factor 2 - Asset Quality - Ba

Factor 3 - Competitiveness -Ba

Factor 4a - 3-year Average Adjusted Days Liquidity on Hand - 223 days

Factor 4b - 3- year Average Debt Ratio - 91%

Factor 4c - 3-year Average Fixed Charge Coverage Ratio - 1.05x

Nothing Factors - None

Grid Indicated Rating - Baa2

Assigned Rating - Baa1

Note: The grid is a reference tool that can be used to approximate credit profiles in the US Municipal Joint Action Agency sector in most cases. However, the grid is a summary that does not include every rating consideration. Please see the US Municipal Joint Action Agencies methodology for more information about the limitations inherent to grids.

ADDITIONAL SECTOR STATISTICS:

Largest Participant (% Share): Village of Lyndonville Electric Department (19.60%)

2013 Post-PILOT Net Revenue DSCR: 1.04x

2013 Days Cash on Hand: 212 days

Debt Service Reserve Fund Balance: $1.9 million

Debt Outstanding (2013): $21,350,000

ISSUER CONTACT

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The principal methodology used in this rating was US Municipal Joint Action Agencies published in October 2012. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

Please see Moody's Rating Symbols and Definitions on the Rating Process page on www.moodys.com for further information on the meaning of each rating category and the definition of default and recovery.

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