MOODY'S
INVESTORS SERVICE

Rating Update: Moody's maintains Baa2 for Vermont Public Power Supply Authority's Lamoille County Settlement Notes; Outlook is Stable

Global Credit Research - 18 Dec 2014

Approximately $8.7 million outstanding

VERMONT PUBLIC POWER SUPPLY AUTHORITY - LAMOILLE COUNTY SETTLEMENT NOTES
Joint Power/Action Agency (JPA)
VT

Opinion

NEW YORK, December 18, 2014 --Moody's Investors Service has maintained a Baa2 rating on the Vermont Public Power Supply Authority (VPPSA) 10-year note that is secured by VT Transco equity certificates. The outlook is stable.

RATING RATIONALE

The rating reflects VT Transco's predictable cash flow profile that is anchored by open access transmission tariff (OATT) revenue earned from ISO-NE and the Vermont distribution utilities under the 1991 Transmission Agreement. The rating considers the essential service that VT Transco provides, the limited operating risk associated with transmission businesses since there is no commodity price risk, and VT Transco's favorable relationship with regulators and the Vermont distribution utilities.

The rating is tempered by potential scenarios where the Vermont Electric Power Company (VELCO) board could reduce the equity rate of return on the Class A and Class B equity units, the weak contractual provisions for collecting from VPPSA members any deficiency in the equity distributions to cover debt service on the note, the lack of dedicated liquidity to support annual debt service costs and repayment, and the potential for a timing mismatch at maturity when VPPSA must repay the note with proceeds from the equity units' sale. The rating further incorporates Moody's view that the notes are structurally subordinate to VT Transco's own debt, particularly since the notes' annual debt service is paid from VT Transco equity distributions.

OUTLOOK

The stable outlook reflects Moody's view that VT Transco's cash flow profile will support equity unit distributions that will cover annual interest costs close to 2.0 times.

WHAT COULD CHANGE THE RATING - UP

The rating is well positioned at the current level and is unlikely to be upgraded.

WHAT COULD CHANGE THE RATING - DOWN

The rating could face downward pressure if VT Transco's credit quality deteriorates or if equity unit distributions see a fall to below 1.5 times annual interest coverage.

LEGAL SECURITY

The notes are secured by an equal amount of VT Transco equity units and annual debt service costs are paid from the annual equity distributions. The weighted average equity unit distribution rate is 12.5% and the annual interest cost on the notes is 6.25%. The notes are non-amortizing and VT Transco has provided the ultimate backstop to repurchase the equity units for par at maturity. VPPSA would then utilize the equity unit sale proceeds to repay the note.

INTEREST RATE DERIVATIVES - None

STRENGTHS

* Predictable cash flow from ISO-NE OATT and Vermont distribution utilities

* VT Transco provides essential transmission services with no commodity risk and limited operating risk

* Class A and Class B equity unit rates of return are defined in the transmission agreement between VT Transco and the Vermont distribution utilities

CHALLENGES

* No dedicated reserve funds or other liquidity to offset potential cash flow timing mismatches

* Equity unit distributions used to cover annual debt service are structurally subordinate to VT Transco's debt

* Weak contractual provisions between VPPSA and its Lamoille County members, on whose behalf these equity units were purchased, in case equity unit distributions are insufficient to cover annual debt service

DETAILED CREDIT DISCUSSION

RECENT DEVELOPMENTS

VT Transco's top line financial performance strengthened during 2013 as total revenues of $158.4 million were 23.7% higher than 2012 results and 2013 operating income of $89.3 million was 27.2% higher than 2012 results. The revenues in 2013 appear significantly higher than 2012 revenues primarily because of tax related accounting reductions to revenues in 2012. Additionally, the difference in 2013 and 2012 revenues was also impacted by an equity issuance at the end of 2012 that increased revenues in 2013, higher interest expense in 2013 due to debt issuance in 2012, and higher depreciation expense and operating expenses.

VT Transco had approximately $22 million in unrestricted cash at YE 2013. VT Transco also has a $40 million unsecured line-of-credit renewed in April of each year. For YE 2013 VT Transco's members' equity was $529.8 million, approximately 11% increase over 2012, and first mortgage bonds for $391.7 million, a 3.4% reduction from 2012, reflecting some debt repayment.

COST OVERRUNS RELATED TO VT TRANSCO'S LAMOILLE COUNTY PROJECT PROVIDES THE BACKGROUNDFOR THE CURRENT TRANSACTION

The Lamoille County Project was a transmission project undertaken by VT Transco that involved the construction of an 115kV transmission line, substations, circuit breakers and switchgear, and the relocation of a 34.5 kV transmission line. Since these facilities were of specific benefit to the distribution systems in North-Central Vermont, the project was classified as a Specific Facility, and thus its costs over the first 10 years are shared by the distribution systems that have a direct benefit. After 10 years, all Specific Facilities become Common Facilities and are factored into general transmission rates.

The total project cost, anticipated to be $20 million, was to be allocated among a group of investor-owned utilities, cooperatives and municipal utilities in Vermont. Shortly after the Vermont Public Service Board issued the certificate of public good, VT Transco's total project cost estimate ballooned to $35 million, which caused a number of the distribution utilities to assert that the cost allocation arrangement was no longer viable. The ultimate project costs became the responsibility of the "Lamoille County Systems", which include the municipal utilities of Stowe, Morrisville, Hardwick, Johnson and Hyde Park as they were the most direct beneficiaries of the project. The Lamoille County Systems filed a FERC complaint regarding the cost allocation for the project where they asked FERC to amend the 1991 Transmission Agreement with VT Transco such that any signatory could terminate service with 60 days notice. Eventually, all parties involved were able to reach a settlement agreement.

The settlement stipulates how the Lamoille County Systems will pay their share of the costs associated with the project for the first 10 years of commercial operation. As part of the settlement, VT Transco will receive a $1.529 million fixed annual payment, distributed pro-rata among the Lamoille County Systems that cannot be increased for any reason. In return, the Lamoille County Systems will acquire a specified number of VT Transco equity units, to be financed with 10-year, taxable, fixed-rate, non-amortizing debt. The periodic cash distributions from the equity units would be applied to the debt service on the debt and the carrying costs of the Lamoille County Project for the first ten years of commercial operation. At debt maturity, the equity units could be sold to other Vermont utilities, if VT Transco had a funding need at that time, otherwise VT Transco would take on the repayment risk and be responsible for providing the ultimate backstop to repurchase the equity units.

VT TRANSCO HAS A PREDICTABLE CASH FLOW PROFILE WITH LOW OPERATING RISK

VT Transco was established in 2006 by VELCO and Vermont's electric distribution companies. The company owns Vermont's high-voltage electric transmission system (115 kV and above) and provides service under applicable FERC tariffs to all electric distribution utilities in Vermont, 2 small distribution utilities in New Hampshire and loads throughout New England via ISO-NE. VELCO manages, operates and maintains the VT Transco system.

VT Transco is a conduit that moves power from generation facilities and interconnection points to distribution nodes in Vermont and other interconnection points. The company provides an essential service and is a monopoly in the state. Transmission services are provided on an open access basis. VT Transco does not have exposure to volume risk since its contracts with customers are structured to provide full recovery of operating expenses, taxes, debt service, and a regulated return on equity, regardless of the amount of power transmitted across the system.

The company's revenue structure is multi-tiered, and the largest percentage of revenue (75% - 80%) is earned from the ISO-NE OATT. VT Transco provides Regional Network Service under the tariff. ISO-NE utilizes the VT Transco transmission system and seven other major transmission systems in New England to provide regional network services. ISO-NE charges and collects transmission revenues from all the New England utilities, and then pays each transmission owner its pro-rata share of total transmission revenue on a monthly basis. Therefore, ISO-NE's transmission revenue requirement can be viewed as a compilation of the revenue requirements from the various transmission owners.

VT Transco's second revenue tier is the revenue earned from amounts billed to local Vermont distribution utilities under the 1991 Transmission Agreement. The amount billed on a monthly basis is the distribution utilities' pro-rata share (based on actual usage) of VT Transco's total costs that were not recovered through other sources, primarily the ISO-NE tariff. Thus, VT Transco will always collect its full revenue requirement, including the amount needed to pay the distributions on its Class A and Class B equity certificates, through a combination of the ISO-NE transmission tariff and amounts billed to the Vermont distribution utilities.

EQUITY DISTRUBTIONS PAY ANNUAL DEBT SERVICE COSTS AND VT TRANSCO PROVIDES THE ULTIMATE BACKSTOP FOR NOTE REPAYMENT

The utility systems of Morrisville, Hardwick, Johnson and Hyde Park are all VPPSA members. Each of the utilities has a separate agreement with VPPSA that gives VPPSA the right to purchase VT Transco equity units on their behalf, and finance the purchase with debt if necessary. In the context of the Lamoille County Settlement, these four utilities felt it would be more efficient and beneficial for VPPSA to consolidate their pro-rata share of the equity securities attributed to them as part of the settlement, and issue one note to cover the full amount, rather than each utility raising debt individually to purchase the equity units.

As described in the terms of the settlement, VPPSA arranged a 10-year, non-amortizing note with a 6.25% interest rate that matures in November 2019. The interest costs on the note will be paid by distributions received from the Class A and Class B equity units that were purchased with note proceeds. Class A equity units pay an 11.5% annual return while Class B equity units pay a 13.3% annual return. VPPSA purchased on behalf of its four members a total of 384,846 Class A units at $10 par and 489,804 Class B units at $10 par. The weighted average return on these equity units is therefore 12.5%. VPPSA receives the distribution from VT Transco on a quarterly basis and pays the debt service on the note with those funds on the specified interest payment dates. Given the annual interest rate on the note, the weighted average equity rate of return, assuming no changes, is sufficient to cover annual interest costs 2.0 times.

The equity rates of return are collected by VT Transco from the Vermont distribution utilities as part of the transmission bill according to the 1991 Transmission agreement. The VELCO board, which is primarily represented by the company's owner-customers, has the ability to reduce the equity rate of return; however the board has not taken that decision after previous deliberations. Additionally, given the current spread between the weighted average equity rate of return and the interest rate on the note, it would take a fairly substantial cut in the equity distribution rates to achieve 1.0 times interest coverage, especially since over 80% of VT Transco's revenue is earned under the ISO-NE OATT. If there is any deficiency between the equity distributions and annual debt service would need to be collected from the four Lamoille County Systems, or through the entire VPPSA membership. However, the language in the Equity Agreement between VPPSA and its individual members that refers to how shortfalls will be collected is much weaker than a take-or-pay obligation that Moody's is familiar with. Therefore, in a situation where equity returns are insufficient to cover debt service, there is the potential for a funding shortfall if VPPSA is unable to collect the deficiency from its membership in time. The situation is further exacerbated since there are no liquidity or reserve funds dedicated specifically to the note to cover any potential shortfalls.

As mentioned above, the Lamoille County Systems are obligated to sell the equity units at par after the first 10 years of operation. The sale proceeds would be used to repay the 10-year note in full. If VT Transco has capital needs at that time, those equity units could be issued among the Vermont distribution utilities. However, if there are no capital needs, VT Transco is obligated per the settlement agreement to repurchase the equity units at par. Therefore, VT Transco has taken on the note repayment risk. Overall, VT Transco's financial position is characterized by its conservative capital structure and predictable cash flow profile. Moody's estimated VT Transco senior unsecured credit quality ranks in the Baa-category. VT Transco's estimated credit quality is the primary source for note repayment.

KEY INDICATORS

Lamoille County Systems: Morrisville (53.0%), Hardwick (22.3%), Johnson (13.4%), Hyde Park (11.3%)

Total Class A Equity Units: 384,846

Total Class B Equity Units: 489,804

Weighted Average Equity Unit Rate of Return: 12.5%

Equity Unit Par Value: $8,746,500

Debt Outstanding (as of December 31, 2012): $8,746,500

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The principal methodology used in this rating was Regulated Electric and Gas Utilities published in December 2013. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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