



August 15, 2011

**VIA Email**

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**Request for Comment: Moody's Considers Use of New Financial Metrics In U.S. Public Power Electric Utility Rating Methodology**

The American Public Power Association (APPA) and the Large Public Power Council (LPPC) submit these comments in response to Moody's Request for Comment dated June 17, 2011.

APPA is the national service organization representing the interests of the nation's 2,000 not-for-profit, publicly owned electric utilities throughout the United States. These utilities are owned by state, municipal or other units of local government, such as public utility districts. Moody's currently rates revenue bonds and other debt issued by approximately 300 public power systems, including both distribution and generation utilities.

The LPPC is an organization representing 25 of the largest locally owned and operated public power systems in the nation. LPPC members own and operate over 86,000 megawatts of generation capacity and 35,000 circuit miles of high voltage transmission lines. LPPC member utilities supply power to some of the fastest growing urban and rural residential markets in the country. Members are located in 11 states and Puerto Rico -- and provide power to some of the largest cities in the country including Los Angeles, Seattle, Omaha, Phoenix, Sacramento, Jacksonville, San Antonio, Orlando and Austin. Collectively, LPPC members have approximately \$80 billion in outstanding municipal bonds.

APPA and LPPC appreciate the opportunity to comment on Moody's proposed new financial metrics for public power. We recognize the need to continually review historical analytical approaches and explore new methodologies that may provide more accurate and meaningful information for investors and issuers alike. However, public power issuers have serious reservations regarding credit rating methodologies that create different and unequal approaches for public power credits relative to the majority of other municipal bond issuers. It is difficult to understand how either investors or issuers are better served by the creation of different metrics for different classes of municipal bonds that are otherwise viewed similarly by investors.

APPA and LPPC understand Moody's interest in analyzing and quantifying public power issuers along a variety of financial metrics. And we can appreciate a desire to compare public power utilities to other electric utilities such as investor owned utilities (IOUs) and electric cooperatives. However, investors will be better served by comparing public power to the other enterprises in which they invest – such as the broader base of municipal revenue bonds. Creating a unique methodology for public power has as much potential to confuse as to inform the investor. The public power community does not support any changes in ratings methodology that will be applied unequally across the overall municipal finance industry.

We believe there are a great many similarities between public power credit structures and those of various other municipal revenue bonds. For example, there are several local governments that have more than one publicly controlled utility or revenue credit. Some local governments have an electric utility, as well as utility functions such as water, sewer, gas, telecommunications, etc. In some cases, the governing body, managers, customers, and financial documents of these separate utility functions are virtually identical. It is very difficult to understand how separate metrics and methodologies for these similar enterprises will be valid or helpful. There are also combined utility systems that include electric, water, sewer, telecommunications and/or gas utilities. At what point will it be appropriate to evaluate a combined utility under either the old or new metrics? In much the same way as Moody's prior ratings recalibration effort seemed to draw questionable distinctions between public power and the larger municipal finance credit arena, these new methodologies might again unfairly isolate public power in the minds of investors.

Moody's has consistently cited as major credit strengths public power's flexibility in setting rates and ability to react quickly to a change in conditions. These governance and management factors are not part of a metric, yet they are a very important part of a utility's rating. Clearly metrics are only part of the credit rating process. Moody's proposal would adjust three key metrics based on additional factors such as transfer payments, take or pay contracts, and the funding of reserves. But Moody's already considers these factors in developing a public power utility's credit rating, just not as a component of the key metrics. Moody's should continue its practice of relying on a mixture of quantitative and qualitative assessments, and resist the impulse to fine tune key metrics only as they apply to the public power sector. The key metrics should remain the same across the municipal finance industry.

In addition to these general concerns for a new methodology that would apply only to public power, we have the following concerns about the three specific proposals from Moody's.

## 1 - Adjusted Debt Service Coverage Ratio

### Moody's Description:

“Adjusted Debt Service Coverage Ratio” recognizes that most public power utilities transfer a portion of surplus revenues to a municipal government. While the transfers come after debt service in the legal flow of funds, practically the transfer is a requirement and in many cases the transfer is made on a monthly basis. Moody's Adjusted Debt Service Coverage Ratio treats the transfer as an operating expense. **Moody's will utilize the Adjusted Debt Service Coverage Ratio as the key coverage metric because it provides a better explanation of a utility's operating results.** Moody's calculates the Adjusted Debt Service Coverage Ratio by dividing annual net revenues (gross revenue and income minus operating and maintenance expenses net of depreciation but including General Fund transfers to the municipal government) by total debt service costs. The ratio measures a utility's ability to repay annual debt service costs from recurring revenues net of recurring expenses, as well as the utility's resiliency to withstand revenue and expense volatility. Declines in the Adjusted Debt Service Coverage Ratio could be indicative of financial strain or an unwillingness or inability to raise rates to fully recover the cost of service.

The vast majority of public power bond resolutions place debt service payments as a senior payment obligation relative to any transfers to local governments. While some utilities make transfer payments on a monthly basis, it is also true that a great many issuers make monthly payments into a debt service fund that is not allowed to be used for any purpose other than debt service. In addition, some utilities have the ability to reduce or terminate the transfer payments if the utility experiences or expects problems making anticipated debt service payments. Transfer payments serve as a buffer that can be reduced in difficult times as opposed to a requirement that must be met prior to debt service. Given this legal structure, the existing, traditional debt service coverage calculation should serve as the key coverage metric for public power and other revenue based credits that make governmental transfers. The existing debt service coverage calculation is more consistent with the current industry standard that is:

- Used by the vast majority of municipal bond investors and analysts,
- Reflective of public power bond resolutions,
- Presented in public power financial statements and disclosure documents, and
- Used as the primary coverage metric by other national rating agencies.

Retaining the traditional and legally accurate calculation as the primary coverage metric would also be consistent with Moody's approach to rating IOUs. Moody's primary coverage metric for IOUs (as described in Moody's August 2009 report on Regulated Electric and Gas Utilities) does not appear to account for IOU dividend payments in a similar manner as Moody's is proposing for the treatment of public power governmental transfers.

Moody's points out that “declines in the Adjusted Debt Service Coverage Ratio could be indicative of financial strain or an inability to raise rates,” but the same is true for declines in conventional debt service coverage metrics. Thus, the new metric does not provide additional value in its ability to indicate financial strain or an inability to raise rates. In fact, the traditional coverage metric provides a better measure of the margin of funds that are legally available to bondholders. APPA and LPPC are not aware of any instance in which a public power utility has elected to make governmental transfers while defaulting on a debt service payment.

Some public power issuers maintain rate stabilization funds that can be drawn upon to meet cash flow needs or offset potential rate increases. APPA and LPPC recommend that deposits or draws from these funds be included in the calculations of recurring revenues. This treatment reflects how most bond resolutions and coverage calculations are constructed.

Moody's proposed Adjusted Debt Service Coverage Ratio would produce materially different results from those calculated by the rest of the industry and could be an inaccurate representation of the funds that are legally available and mandated to meet debt service obligations. We believe that investors and issuers are better served by maintaining the traditional debt service coverage calculation as a historic, consistent, and industry-wide measure that provides valuable information to investors.

## **2 – Fixed Obligation Charge Coverage Ratio**

### Moody's Description:

The Fixed Obligation Charge Coverage Ratio incorporates debt like obligations related to the ownership of generation assets through a joint power agency (JPA) under take-or-pay contracts. Many public power electric utilities finance the development or purchase of generation assets through JPAs to increase power reliability, diversify the power resource mix, and lower power costs. Moody's views these contractual obligations as fixed and the annual payments as debt like obligations. Moody's Fixed Obligation Charge Coverage Ratio subtracts the take-or-pay contractual payment from the utility's operating expenses when calculating net revenues, and subsequently adds the take-or-pay contractual payment to the total debt service costs when calculating coverage. The Fixed Obligation Charge Coverage Ratio facilitates uniform comparisons of utilities that directly finance generation assets on balance sheet with utilities that finance assets through JPAs off balance sheet. Moody's uses the Fixed Obligation Charge Coverage Ratio in its analysis of financial results to provide a more consistent comparison of utilities, regardless of the approach to financing generation asset ownership.

APPA and LPPC recognize that there is value in analyzing and quantifying off balance sheet obligations (such as take-or-pay contracts with JPAs) that are the basis for financing a significant number of public power projects. However, we believe that it is very important to correctly determine which of these obligations, or portions thereof, are not only fixed in nature but also directly tied to the JPA's debt obligations. The ratio's denominator is a measure of debt service costs, so it should include only those contract payments, or portions thereof, that go towards payment of debt service. The denominator should not include any other operating or capacity charges that are subject to reduction if the asset is not performing or operating.

We also believe that transfer payments discussed in #1, above, should not be treated as an operating expense for purposes of calculating the fixed obligation charge coverage ratio.

### 3 – Adjusted Days Cash on Hand Ratio

#### Moody's Description:

Moody's current days cash on hand ratio takes a conservative view of a public power utility's liquidity profile by only including available cash and investments in the calculation. Other liquidity components, including legally required reserve funds, external bank lines of credit, and collateral posting requirements, are considered in our overall liquidity assessment, but are not included in this primary liquidity metric. The current days cash on hand ratio is calculated based on a utility's available and unrestricted cash and investments times 365 days divided by a utility's annual operating and maintenance expenses. **Moody's will replace the traditional days cash on hand ratio with the Adjusted Days Cash on Hand Ratio which subtracts from available cash and investments any actual collateral posting requirements with a counterparty and the difference between a fully funded annual debt service reserve and the actual debt service reserve funding level maintained by the utility.** Debt service reserves funded with surety policies provided by low or unrated financial guarantors are assumed to have no value. Public power utilities have vastly different approaches to debt service reserve funds. Some have fully cash funded reserves equal to a full year's debt service requirements; others have no debt service reserve, while others have something in-between. The Adjusted Days Cash on Hand Ratio provides better comparability across all utilities by reducing the available days cash on hand by the amount of the debt service reserve deficiency. Additionally, Moody's will evaluate external liquidity sources such as bank lines of credit, but will only include them as available cash and investments if they are undrawn and meet our more stringent credit standards, such as no material adverse changes (MAC) clauses which permit banks to deny the utility's funding request and/or terminate the credit agreement for non credit related events. Where applicable, Moody's calculation of the Adjusted Days Cash on Hand Ratio will utilize the adjusted operating expenses derived from calculating the Adjusted Debt Service Coverage Ratio and/or the Fixed Obligation Charge Coverage Ratio.

Days Cash on Hand is a liquidity measure – an indicator of whether the entity has the financial flexibility to manage through short term periods of volatile cash flows. APPA and LPPC believe that adjusting the measure based on the level of debt service reserves mixes assets that have two separate purposes and is not a useful way to measure liquidity. Moody's could address debt service reserves through a separate metric or in a qualitative assessment as part of its credit rating. Including information on debt service reserves as part of a liquidity measure, however, is inappropriate, as more fully described below.

Moody's proposed Adjusted Days Cash on Hand ratio seemingly values non-restricted cash and investments as equally available to cover cash flow variability as monies held in a highly restricted debt service reserve. Neither issuers nor investors view debt service reserve funds as readily and routinely available to be used for debt service payments, let alone to be used for operating payments. Virtually every public power bond resolution requires electric rates to be set at or above a level such that debt reserve funds are never used for operating or debt service payments. APPA and LPPC are not aware of any public power borrower in the past 20 years that has used debt service reserve funds to meet debt service obligations. The inclusion of a debt service reserve – which is often a function of the amount of debt on the balance sheet – in an operating cash metric that is driven by income statement operating expense, is an inappropriate and potentially confusing mix of balance sheet and income statement items.

Clearly, “real” cash and investments are much more important and valuable to issuers and investors as a measure of liquidity. It is also the case that a very strong utility, with low rates, strong ratemaking flexibility, and solid financial metrics, but without a debt service reserve fund, could actually have an Adjusted Days Cash on Hand Calculation that results in a very low or even negative number. Investors may have a difficult time understanding how the new calculation could be a more meaningful metric if this were the case.

There is no “proper” or “best” level of funding of debt service reserves. There is a high degree of variability among borrowers, ranging from no debt service reserve fund up to amounts that exceed maximum annual debt service. The sizing of a reserve requirement is a management decision based on a combination of risk factors that are unique to each utility. The proposed Adjusted Days Cash on Hand ratio will likely encourage utilities to increase the level of funding of debt service reserves, and this may not be the best decision for some utilities and their ratepayers. Debt service reserves are often funded with the proceeds of long-term, fixed rate bonds and typically invested in high quality investments that are much shorter in duration. The cost of carry on these reserves can be as high as 4 to 5 percent annually. Some highly rated utilities have been able to achieve their strong ratings based on other factors and despite having relatively low reserve requirements. Currently, this is a benefit of their strong ratings, but the benefit could disappear if Moody’s expects all utilities to carry large, virtually inaccessible, reserve funds. Moody’s should continue to use the standard Days Cash on Hand ratio, which is the measure of liquidity used throughout the municipal finance industry, and allow public power managers the flexibility to determine the most appropriate reserve funding for the utility. Moody’s evaluation of management’s decisions can easily be factored into the credit rating process.

Moody’s also proposes to evaluate external liquidity sources, such as bank lines of credit, but will only include them as available cash and investments if they are undrawn and meet Moody’s more stringent credit standards, such as no material adverse changes (MAC) clauses. This is another area where it is important to ensure that public power is not treated differently from the rest of the municipal issuer universe. It would also be helpful for Moody’s to publish clear standards that would qualify a bank facility for inclusion in the calculation. We recognize that Moody’s standards have changed, but are not aware of any past publications that clearly outline the past practices or recent changes.

**Summary**

For the reasons outlined above, APPA and LPPC believe that it is in the best interest of both issuers and investors that Moody's refrain from implementing the new methodologies. This is another change, in addition to ratings recalibration, that segregates public power from the rest of mainstream municipal finance. We do not believe that these new metrics will provide more accurate predictive value than existing conventional metrics, and in fact think that the changes will raise more uncertainty than understanding. APPA and LPPC appreciate the opportunity to respond to Moody's proposal and encourage Moody's to evaluate public power credits consistently with other municipal sectors.

Thank you for consideration of our comments.

Sincerely,



Mark Crisson, President and CEO  
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