Austin Energy Rate Case: Municipal Bond Ratings

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Municipal Bond Credit Ratings

- A credit rating is a comprehensive tool for assessment of an issuer's credit worthiness.
- Higher ratings equal lower borrowing cost.

Standard Rating Categories

Moody's		S&P		Fitch	
Long Term	Short Term	Long Term	Short Term	Long Term	Short Term
Aaa	P-1	AAA	A-1+	AAA	F1+
Aa1		AA+		AA+	
Aa2		AA		AA	
Aa3		AA-		AA-	
A1		A+	A-1	A+	F1
A2		A		A	
A3	P-2	A-	A-2	A-	F2
Baa1		BBB+		BBB+	
Baa2	P-3	BBB	A-3	BBB	F3
Baa3		BBB-		BBB-	

Ratings below BBB are not considered investment grade

<u>Rating Outlook</u>

Positive-suggests that the rating may be raised

Stable-suggests that the rating is unlikely to change.

Negative-suggests that the rating may be lowered

Austin Energy Bond Ratings

	Electric Utility Separate Lien Bond Ratings	Combined Utilities Prior Lien Bond Ratings
Moody's	A1/Stable	A1/Positive
S&P	A+/Positive	AA/Positive
Fitch	AA-/Stable	AA-/Stable

Bond ratings affect: $212,723,326 Prior Lien Principal
$185,084,512 Subordinate Lien Principal
$1,176,985,000 Parity Lien Principal

Rating Criteria

- Economy
  - Major Economic Drivers
  - Employment
  - Income and Wealth
- Debt and Other Long-Term Liabilities
  - Ratios and Trends
  - Future Capital and Debt Needs
  - Debt Structure
- Finances
  - Revenue and Expenditure Analysis
  - Operating Margin Trends
  - Fund Balance/Reserves
  - Liquidity
- Management and Administration
  - Institutional Policies
  - Budgeting Practices
  - Stability of Management
  - General Governance

Moody's Scorecard Factors and Sub-factors

- **FACTOR 1 – (25%)** Cost Recovery Framework within Service Territory
- **FACTOR 2 – (25%)** Willingness & Ability to Recover Costs with Sound Financial Metrics
- **FACTOR 3 – (10%)** Management of Generation Risks & Cost & Reliability of Power Supply
- **FACTOR 4 – (10%)** Rate Competitiveness
- **FACTOR 5 – (30%)** Financial Strength and Liquidity (all three year averages)
  - Sub-factor 5A – (10%) Adjusted Days Liquidity on Hand
  - Sub-factor 5B – (10%) Debt Ratio
  - Sub-factor 5C – (10%) Adjusted Debt Service Coverage

Moody's Scorecard Factors and Sub-factors

- **FACTOR 1 – (25%) Cost Recovery Framework**
  - Monopoly with unregulated rate setting
  - Service area economic strength
    - Unemployment, diversity of customers and general economic diversity

Aaa	Aa	A	Baa
Monopoly with unregulated rate setting; Very strong service area economy	Monopoly with unregulated rate setting; Strong service area credit economy	Monopoly with unregulated rate setting; Average service area economy	Regulation of rates by State; Weak service area economy

Moody's Scorecard Factors and Sub-factors

- **FACTOR 2 – (25%) Willingness & Ability to Recover Costs w/ Sound Financial Metrics**
  - Rate setting record & Timeliness of recovery
  - Political risk & Local Government Supportiveness
  - General Fund transfers
  - KEY to scoring is the above in the context of their financial metrics, noting that issuers can score one category above where their metrics may indicate

Aaa	Aa	A	Baa
Excellent rate-setting record; Rates, fuel, & purchased power cost adjustments less than 10 days; No political intervention in past or extremely high support from related government; Very limited General Fund transfers governed by policy	Strong rate-setting record; Rates, fuel, & purchased power cost adjustments 10 to 30 days; Limited political intervention in past or high support from related government; Conservative and well-defined General Fund transfers governed by policy	Adequate rate-setting record; Rates, fuel, & purchased power cost adjustments 31 to 60 days; Some political intervention in past or average support from related government; Moderate General Fund transfers	Below average rate-setting record; Rates, fuel, & purchased power cost adjustments 61 to 99 days; Persistent political intervention or below average support from related government; Large General Fund transfer not governed by policy

Moody's Scorecard Factors and Sub-factors

- **FACTOR 3 – (10%) Management of Generation Risk & Cost and Reliability of Power Supply**
  - Diversity of generation and fuel supply
  - Reliability and cost of supply & distribution
  - Single generation asset and/or carbon fuel concentration could lower score

Aaa	Aa	A	Baa
Very strong management of generation risks; High degree of diversification of generation and/or fuel sources; Well insulated from commodity price changes; Single generation asset typically provides less than 20% of power; and/or up to 20% of energy from coal-fired generation with carbon mitigation strategy	Strong management of generation risks; Some diversification of generation and/or fuel sources; Minimally affected by commodity price changes; Single generation asset typically provides less than 40% of power; and/or 21% to 40% of energy from coal-fired generation with carbon mitigation strategy	Average management of generation risks; Some reliance in one type of generation or fuel source, but diversified with purchased power sources; Modest exposure to commodity price changes; Single generation asset typically provides 40% to 55% of power; and/or 41% to 55% of energy from coal-fired generation with carbon mitigation strategy	Below average management of generation risks; Reliance on a single type of generation or fuel source, with limited diversification via purchased power; Moderate exposure to commodity prices; Single generation asset typically provides 56% to 75% of power; and/or 56% to 70% of energy from coal-fired generation with no carbon mitigation strategy

Moody's Scorecard Factors and Sub-factors

- **FACTOR 4 – (10%) Rate Competitiveness**
  - Benchmark is utility system rate compared to the state average (EIA data 2009)
  - Rating committee may override the comparison to the average state rate to accurately reflect the utility's current rate competitiveness, as the EIA data is historic. This can also better reflect the utility's regional competitive position compared to the local IOU, as well as better reflecting the competitiveness for a specific key customer class as opposed to the system wide rate.

Aaa	Aa	A	Baa
More than 25% below average	25% to 7.51% below average	7.5% below average to 7.5% above average	7.51% to 25% above average

Moody's Scorecard Factors and Sub-factors

- **FACTOR 5 – (30%) Financial Strength and Liquidity (all three year averages)**
  - Sub-factor 5A – Adjusted Days Liquidity on Hand
  - Sub-factor 5B – Debt Ratio
  - Sub-factor 5C – Adjusted Debt Service Coverage

Sub-factor	Aaa	Aa	A	Baa
Adjusted days liquidity on hand (days)	≥ 250 days	≥ 150 days to 249 days	≥ 90 days to 149 days	≥ 30 days to 89 days
Debt ratio (%)	Less than 25%	≥ 25% less than 50%	≥ 50% less than 75%	≥ 75% less than 100%
Adjusted Debt Service Coverage (x)	≥ 2.50x	≥ 2.00x to 2.49x	≥ 1.50x to 1.99x	≥ 1.10x to 1.49x

Moody's Scorecard Factors and Sub-factors

- **Rating Actions Considerations**
  - **Operational**
    - Customer Concentration, additional borrowing needs, construction risk
      - Concentration - ½ to 1 notch depending on contribution to revenues - top 10 are mostly corporate customers and are about 30% or above or a single or small number of corporate customers above at least 10% to 15%
      - If utility receives minimal margin and has no stranded capital investment if the large customer leaves then we may reduce notching
  - **Financial**
    - Covenant or Derivative Risks, Financial Engineering, VRDO/Swap exposure, liquidity related risks
    - Debt Service Reserve Funding – below 50% Maximum Annual Debt Service (MADS) can result in ½ to 1 notch down and DSRFs that are 50% to 85% funded can result in 0 to ½ notch down
  - **Other** - Factors not appropriately captured in the grid

Austin Energy Definition of Reserves, Financial Policies

Description	Policy #	Date Adopted	Date Revised	Target Amount	Current Amount FY2012 Budget Ending Balance	Target Amount	Test Year Revenue Requirement	# Years to Replenish per Financial Policy	# Years to Replenish in Rate Proposal
Operating Cash	11	FY1989	N/A	Minimum of 60 days of non-power supply operating requirements	$38,000,000	$51,668,168	$0	Not specified	3 years
Repair and Replacement	15	FY2002	FY2012	Maximum of 50% of previous years electric utility depreciation expense.	$64,071	$61,197,672	$20,399,224	Not specified	3 years
Non-nuclear decommission-ing	21	FY2002	N/A	Funding will be set aside over a minimum of four years prior to the expected plant closure	$8,000,000	$55,577,818	$5,557,782	Funding will be set aside over a minimum of four years prior to the expected plant closure.	10 years
Strategic Reserve – Emergency	16	FY1997	FY2002	Minimum of 60 days non-power supply operating requirements	$68,890,890	$68,890,890	$0	Not specified	N/A. Currently fully funded.
Strategic Reserve – Contingency	16	FY1997	FY2002	Maximum of 60 days of non-power supply operating requirements.	$68,701,568	$68,890,890	$189,322	Balance will be replenished to the targeted amount within two years.	Currently deficient
Strategic Reserve – Rate Stabilization. Previously - Competitive Reserve	16	FY1997	FY2012	Maximum 90 days of non-power supply operating requirements.	$0	$98,158,450	$3,946,811	Not specified	3 years

Source: Austin Energy

Fitch: U.S. Public Power Rating Criteria

- **Select Financial Metrics (Retail Systems)**

Debt Service Coverage (x)	Days Cash on Hand	Equity/ Capitalization (%)
Midrange:		
Target coverage in the 1.5x-2.0x range.	Target approximately 60-90 days operating cash.	Maintain 20%-40% equity levels.

A Rating | Median for A Rated Utilities | 60-90 days

Entity	Days Cash on Hand
Austin Energy (Proposed)	**55**
Austin Energy (Current)	**55**
San Antonio-CPS	121
Anaheim Electric	115
Jacksonville Electric Authority	77
Orlando Utilities	182
MEAG Power	107
Sacramento Municipal Authority	158
Lincoln Electric System	152

Source: Fitch Ratings

Recent Rating Reports Rationale

- S&P (05/21/2010)- "Although fiscal 2009 results indicate weaker debt service coverage**, if management can restore financial performance to its historically strong level and maintain strong liquidity**, we could raise the ratings."
- S&P (01/06/2012)- "If coverage levels improve while what we view as strong liquidity is maintained and accommodating the systems capital plan, we could raise the rating to 'AA-'. We could revise the outlook to stable **if the system does not make progress on increasing financial margins, whether through revenue shortfalls or rising expenditures**." S&P also noted the lack of rate increase over the past 17 years.
- Fitch (07/07/2010)- cited the following factors as Key Rating Drivers – "Maintenance of financial metrics (DSCR, liquidity, operating margin, and leverage) consistent with the rating level .... and ...The Austin City Council and management's willingness to raise rates in a timely manner as necessary." Utility "will be under fiscal pressure for the next two years before the rate increase takes affect .... AE **faces the potential of continued declining margins in the absence of earlier rate increases**."

Recent Rating Reports Rationale

- Moody's however was more elaborative in its comments with the following points worthy of mention (05/24/2010):
  - Historically strong finances have come under pressure: **increase in the base rate will be key for long -term financial stability**.
  - The rating outlook has been changed to stable from positive. The stable outlook reflects Moody's acknowledgement of uncertainties related to the utility's budgetary and debt positions in the next couple of years, while expecting that management and **policy makers will take steps to provide for the financial stability of the system**.
  - The **rating could change downward if debt service coverage margins decline or if the transfers to the city's general fund increases** to levels that weaken the utility's own finances.

A Rating

Debt should be in the range of 51-75%
Cash funding should be in the range of 25-49%

- At 50%, Austin Energy's debt to equity is at the upper end of the A range.
- Cash on hand is well below the median for an "A" rated credit.

Fitch Liquidity Evaluations

- "[expanded] its list of public power guideline factors to include a separate item **focusing exclusively on financial liquidity and risk management**."
- "…Fitch's evaluation of a utility's liquidity profile involves a case-by-case review of utility-specific risk factors. Fitch believes there is no direct link between a specific liquidity level and a rating category. A review of Fitch's ratings among public power and electric cooperatives illustrates, however, that a **strong liquidity position relative to its risk profile is highly correlated with a strong credit rating.** It is also Fitch's assessment that rating changes based solely on liquidity position can be appropriate and material."
- "Liquidity is defined as the availability of cash or cash equivalent resources for meeting an entity's financial obligations. This definition incorporates tangible (e.g., cash) and intangible (e.g., ability to change rates) assets. In addition, Fitch considers the speed with which an entity can access its liquidity. This distinction is important, as **having immediate access to liquidity is preferable to qualifying access to either a time delay or other potential obstacles**."
- "Cash…In most cases, cash reserves are the most timely and accessible sources of liquidity. In the past, utilities generally kept cash balances of 30-60 days of annual operating expenses. Currently, many public power utilities have set aside greater amounts to pay unexpected expenses, lower rates in the future or fund future capital projects. Regardless of the intended use, **if the cash is not restricted (through bond ordinance and board policy), these cash balances can be drawn upon and used as a substantial hedge against unexpected and immediate liquidity needs**. Fitch also believes that cash earmarked to a specific capital project can be source of liquidity given a utility's ability to internally borrow these funds and pay itself back over time…"

Municipal Bond Ratings-Peer Ratings

Entity	Credit Rating (Fitch/Moody's/S&P)	Governance	Most recent base rate change	Next rate change expected
Austin Energy (Electric only)	AA-/A1/A+	City Council/City Management	1994	Currently Reviewing
San Antonio-CPS Energy	AA+/Aa1/AA	Independent Board appointed by City Council	2010	2012
Georgetown Utility Services	AA-/Aa2/AA-	City Council/City Management	1998	Currently Reviewing
Denton Municipal Electric	NR/A1/AA-	City Council/City Management	2005	N/A
College Station Utility	NR/Aa2/A+	City Council/City Management	2010	2011
Lubbock Power & Light	A+/A1/AA-	Governing Board reports to City Council, Not City Management	2010	N/A
Orlando Utility Commission	AA/Aa1/AA	Separate Board	2009	N/A
City Utilities of Springfield	NR/Aa2/AA3	Separate Board appointed by Council	2010	2011
Gainesville Regional Utilities	AA/Aa3/AA	City Department	2010	2011

Municipal Bond Ratings-Peer Ratings

CPS Energy (San Antonio)

Fitch:

- Solid Financial Performance: Financial Margins have been consistently healthy at over 2.2 times (x) debt service coverage or 1.5x, including the large 14% general fund transfer, in recent years.
- With unrestricted cash of $814 million, including its repair and replacement fund, or 243 days cash on hand.
- Rates are competitive and regular rate increases occur approximately every two years.

S&P:

- San Antonio's city council demonstrated its support of CPS Energy's strong financial risk profile when it approved a 7.5% base rate increase for electric rates.

Moody's

- Management expects modest rate increases every other year starting in FY 2013 to maintain debt service coverage (DSC) and liquidity ratios at levels that are adequate for the rating. It expects to maintain DSC at about 1.5x. We calculate the ratio after the annual transfer of funds to San Antonio. The payment to the city is limited to 14% of gross revenue, and has generally been about 13%.
- Adjusted debt service coverage that falls below 1.50 times would pressure the current rating level.

Austin Energy Historical Coverage Ratios

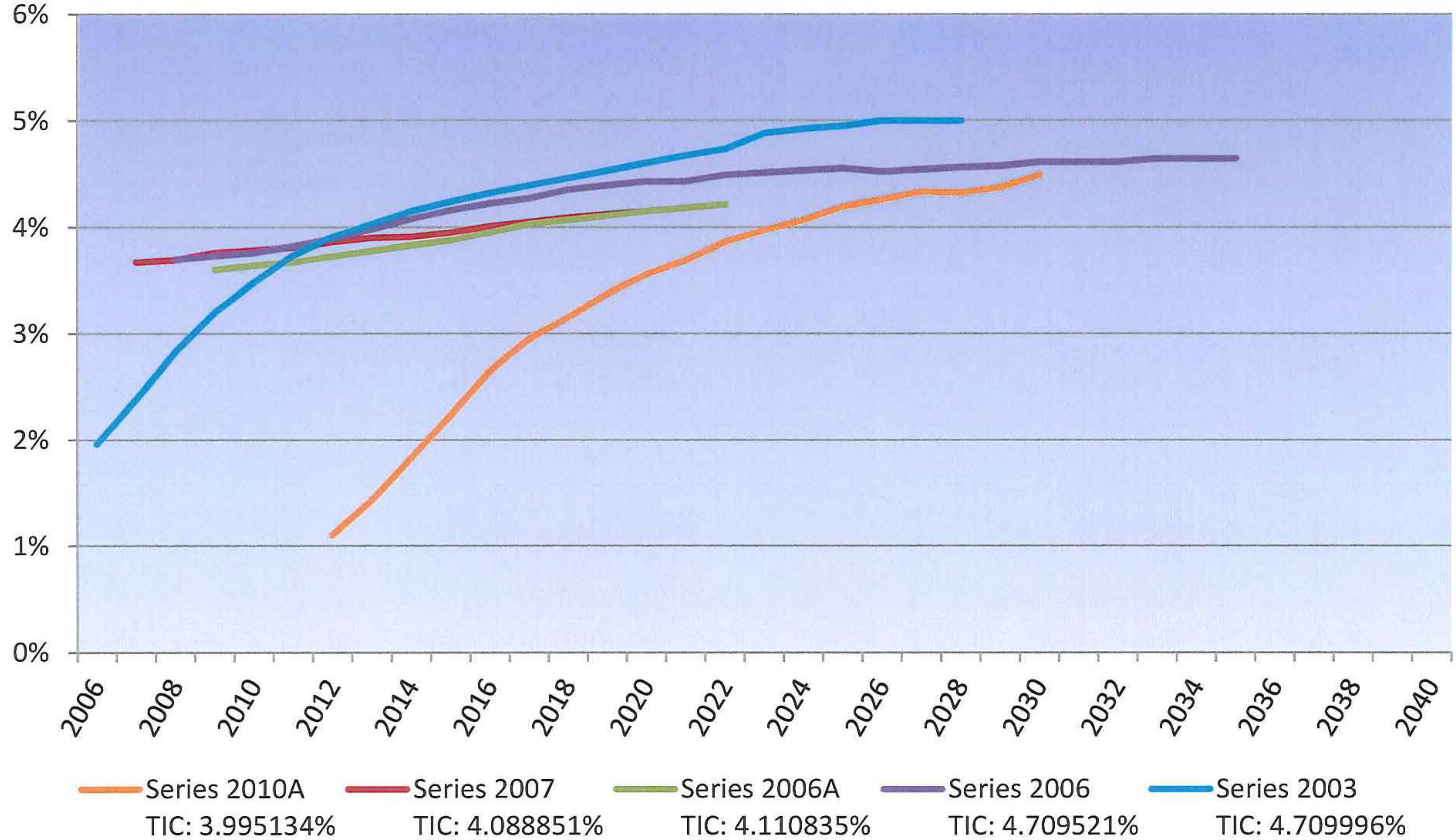
Operating Summary						
	2011 [1]	2010 [1]	2009 [2]	2008 [2]	2007 [2]	2006 [2]
Gross Revenues	$1,258,871	$1,157,417	$1,179,688	$1,260,817	$1,096,869	$1,103,665
Maintenance and Operating Expenditures	901,368	867,970	851,736	840,753	707,053	692,583
Net Revenues	$357,503	$289,447	$327,952	$420,064	$389,816	$411,082
Principal and Interest on Prior Lien/ Prior Subordinate Lien Revenue Obligations	$76,153	$79,511	$92,720	$87,726	$117,951	$88,681
Principal and Interest on Separate Lien Obligations	$97,635	$85,588	$78,430	$68,603	$50,035	$50,282
Total:	$173,789	$165,100	$171,150	$156,329	$167,986	$138,963
Debt Service Coverage (All AE Revenue Obligations)	2.06x	1.75x	1.92x	2.69x	2.32x	2.96x
General Fund Transfers (Expenditure)	103,000	101,000	95,000	91,000	84,500	77,420
Net Revenues available after GF Transfer	$254,503	$188,447	$232,952	$329,064	$305,316	$333,662
Debt Service Coverage (after GF Transfer)	1.46x	1.14x	1.36x	2.10x	1.82x	2.40x
Other Transfers (Expenditure)	52,097	53,131	52,872	46,088	44,014	41,484
Net Revenues available after Other Transfers	$202,406	$135,316	$180,080	$282,976	$261,302	$292,178
Debt Service Coverage (after Other Transfers)	1.16x	.82x	1.05x	1.81x	1.56x	2.10x

[1]: *Austin Energy*
[2]: *COA CAFR FY 2010*

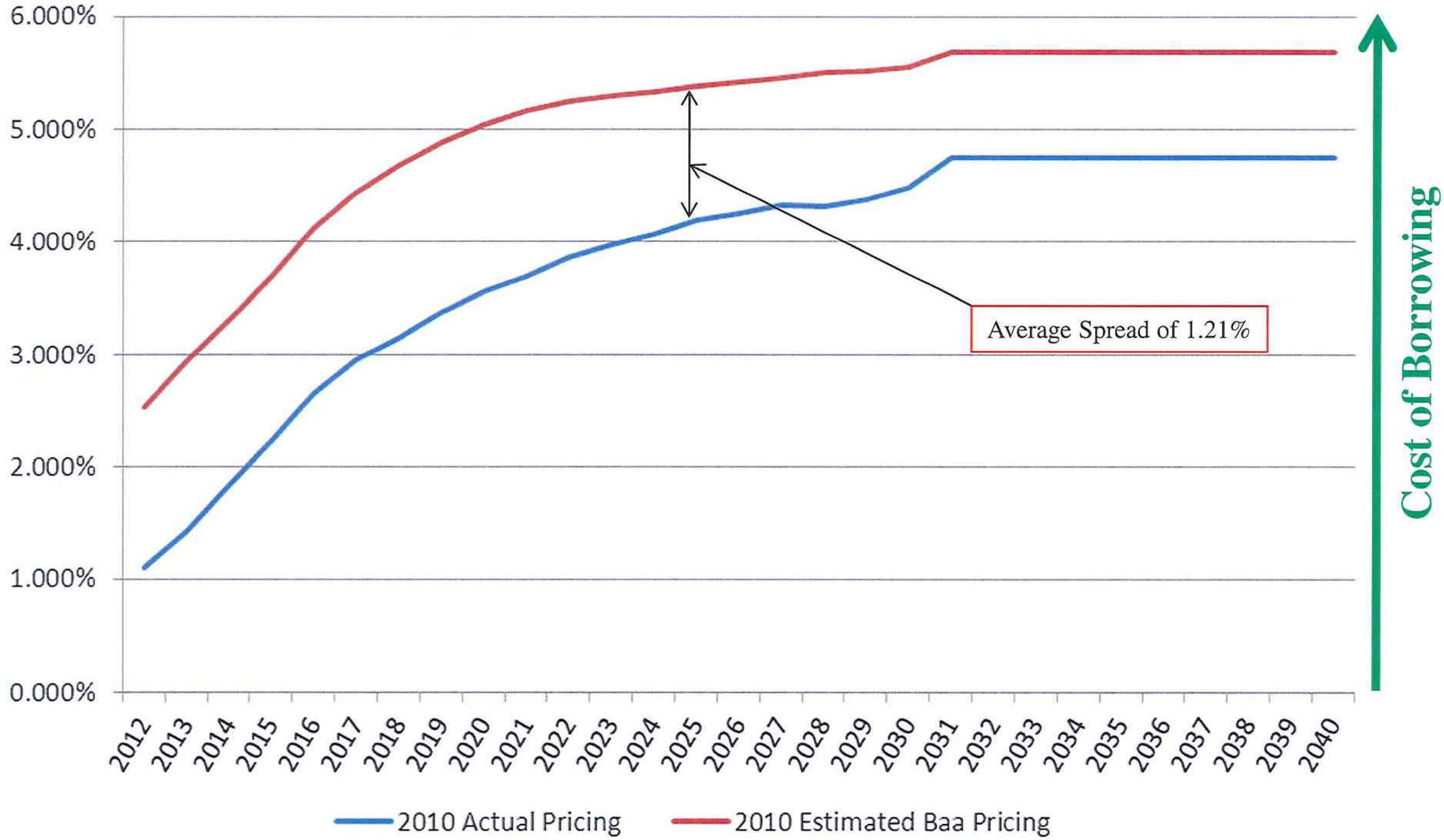
Financial Performance

Recent Historical Austin Energy Performance						
	FY 2012 Budget	FY 2011	FY 2010	FY 2009	FY 2008	FY 2007
Excess (Deficiency) of Total Available Funds over Total Cost	($77,556,527)	$2,755,691	($86,078,997)	($75,886,031)	$63,482,803	$45,272,595
Ending Cash Balance (Operating Fund)	$38,000,000	$144,000,000	$153,000,000	$237,000,000	$247,000,000	$267,000,000

Historical Pricing



Pricing Impact of Downgrade



Note: An 1.21% increase in rates would raise the aggregate debt service requirement on a $100 million bond issue by over $27 million.

Summary

- AE's financial margins have declined significantly for the past 2 years.
- Cash on hand and debt service coverage are well below that required of an "A" rated electric utility.
- In 2010, all three rating agencies put AE on notice regarding potential credit concerns – if financial margins do not improve.
- Staff has clearly defined the rationale/necessity for a substantial rate increase.
- An immediate & adequate increase in rates MAY prevent AE's rating and/or outlook from being downgraded.