Bond Case Briefs

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S&P Credit FAQ: All-In Coverage, Transfer Payments, and Credit Quality.

U.S. local and regional governments commonly have some kind of financial interplay between the general government and other affiliated enterprises, such as municipally owned utilities. In fact, it is uncommon for there not to be some kind of transfer payment. As Standard & Poor's Ratings Services noted in "Methodology: Definitions And Related Analytic Practices for Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations," published Nov. 29, 2011, transfers are based on an open flow of funds, meaning that after all operating expenses have been paid and other covenanted funds are filled, surplus net revenues can be used for any lawful purpose, including movement to another governmental fund, department, or component unit.

Just as there are many different labels for these transfer payments — payment in lieu of taxes (PILOT), franchise fees, and the like — so are there many perfectly reasonable justifications for these payments to take place. Most often, the general government considers its capital and credit quality to be at risk based on its ownership and operation of an enterprise, such as a utility, and the general government deems the transfer payment as a return on the investment for taking that risk. Other very common reasons for transfer payments from the utility to the general government include:

- Reimbursements for direct or indirect costs, such as the use of city easements for a utility line or a portion of the city manager's time allocated to supporting utility operations;
- Covering the utility's share of pension and/or postemployment benefit obligations paid by the general government on behalf of all municipal workers, including the utility's employees;
- Supporting debt that perhaps is legally secured by general obligation taxes but in practice is paid from surplus net revenues of utility operations; or
- Plugging a budget gap in the general fund or otherwise subsidizing general government operations.

To provide additional transparency and clarity about Standard & Poor's view of transfer payments, we have provided answers to questions that we commonly are asked.

Frequently Asked Questions

To what extent do transfers from the utility fund to the general fund affect credit quality?
The mere existence of transfers is so commonplace that the analyst will look to what logic, if any, is behind the transfer. Some transfers are driven by a formula, such as a percentage of gross operating revenues, the net depreciable value of the utility system's assets, or the number of units sold of a utility's services. Predictability and discipline lend themselves to being credit-neutral. Open-ended transfer payments are usually a credit negative.

What are open-ended transfers?
Open-ended transfers occur when a general government can take as much of the utility's surplus cash as it deems necessary. We would usually view this as a credit negative to both the general and

utility funds. Open-ended transfers imply that the general fund is structurally imbalanced, is being subsidized (probably materially) by ongoing utility operations, and is vulnerable to fluctuations and negative budget variances in the utility fund. It is also harmful to the utility because it is an impediment to the utility accumulating and maintaining cash reserves that might otherwise be available for ongoing utility needs, unbudgeted emergencies, or debt-free system reinvestments.

How does Standard & Poor’s determine if, in its opinion, there is an over-reliance on utility transfers?
Standard & Poor’s core coverage metric is all-in coverage, also known as fixed-charge coverage, which we view as the best way to track the use of every dollar of utility operating revenues. This metric is our adjusted debt service coverage metric that treats certain debt-like obligations as if they were the actual debt of the utility, even if legally they are treated as an operating expense, such as contractual take-or-pay minimums or capacity charges. This metric also treats transfer payments as an operating expense. While we understand that under most bond indentures transfers are considered a use of surplus net revenues, we view them as recurring obligations of utility operating revenues and, therefore, include them. Weak all-in coverage, usually near or even below 1.0x, could indicate that transfer payments are relatively large, among other risks.

What is the formula for all-in coverage?
[(Revenues – Expenses – Total Net Transfers Out) + Fixed Costs] /(All Revenue Bond Debt Service + Fixed Costs + Self Supporting Debt Service)

Total net transfers out are defined as transfers from the utility fund minus transfers into the utility fund, including but not limited to:

- Transfers that are viewed as general fund resources, such as a payment in lieu of taxes, indirect cost reimbursements, and open-ended transfers;
- Transfers that reimburse the general fund for pension and other postemployment benefit (OPEB) payments the general fund made on behalf of utility employees and retirees;
- Transfers that fund pay-as-you-go capital expenditures in another governmental fund; and
- Transfers to support any other governmental operations regardless of the destination fund.

We deem net transfers out that legally or by practice support debt service of another governmental fund as part of the denominator’s self-supporting debt. Cash that does not truly leave the utility, such as a set-aside into a rate stabilization reserve or pay-as-you-go fund are not included as transfers out. Similarly, the application of a rate stabilization fund (RSF) or other cash on hand as a transfer in would not be included in the all-in coverage calculation

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee.

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