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Rating Update: **MOODY'S DOWNGRADES CITY OF BURLINGTON'S (VT) ELECTRIC SYSTEM REVENUE BONDS RATING TO Baa2 FROM A3; THE OUTLOOK IS STABLE**

Global Credit Research - 13 Oct 2010

Burlington Electric Department has $43 million of rated debt outstanding

Electric Utilities
VT

Opinion

NEW YORK, Oct 13, 2010 -- Moody's Investors Service has downgraded the rating of Burlington (City of) VT Electric System Revenue bonds to Baa2 from A3 and assigned a stable outlook. The downgrade is primarily related to recent volatility in purchase power prices that have increased rates above average. In addition, the below 1.0 times debt service coverage ratio in FY2009, the department's exposure to increasing market purchase power costs due to loss of long term contracts, and the negative outlook on City of Burlington's (VT) A2 rating caused by city's reduced liquidity weigh on the credit. The Baa2 rating also recognizes the Burlington Electric Department's (BED or department) 1.8 times DSCR in FY2010 and the management's active search for long term fixed priced power supplies.

RATINGS RATIONALE

The department's debt service coverages in 2008 and 2009 were extremely low at 1.25x and 0.86x, respectively, due to the loss of two contracts, which accounted for approximately 30% of department's power supply. The department had to increase its power purchases from the ISO New England market at high costs in order to meet its power supply requirements.

After the breach of the 1.25x rate covenant in 2009, the BED increased its electric rates by 11.3%. The department recovered from its losses in FY 2010 and achieved a DSCR of 1.81x with the help of the rate adjustment and lower market prices. Management continues to look for more contracts to mitigate its exposure to purchase power risk.

Since 2008, City of Burlington has struggled with its liquidity due to problems arising from its telecom undertakings . The city's rating was downgraded on June 2010 to A2/NEG from Aa3 when the city used approximately $17 million from its General Fund pooled cash account for telecom purposes. The Electric Department does not contribute to the General Fund and was not affected by this event. However the city's unstable situation adds risk to the Electric Department.

RATING FACTORS

CITY'S CURRENT OUTLOOK AFFECTS THE CREDIT

The Burlington Electric Utility Department is the exclusive provider of electric service to the city and Burlington International Airport. Based on Moody's Economy research, Burlington's recession is moderating, as the unemployment rate has come down by a percentage point from a year ago, to 5.5.%. One of the Burlington Electric Department's biggest customers, Fletcher Allen Health Care (rated Baa1), is among the area's top employers, leading the local industry. The University of Vermont (rated Aa3) is another major customer.

These two entities represent 15% and 10% usage, respectively, since 2001. The department has been able to maintain its mix of residential and commercial customers with concentration on non-residential customers. In 2010, 64% of the revenue came from commercial and industrial customers, and 24% came from residential. Customer concentration and the slow annual energy demand (averaging less than 1% growth annually since 1990s) is already reflected in the rating and does not create an immediate concern.

Moody's methodology considers the extent to which a utility serves customers located in a municipality's jurisdiction and are subject to the same economic factors. We recognize there is a limited linkage of local government to the Burlington Electric Utility Department due to the closed loop flow of funds structure, therefore the department is not heavily affected by the City's telecom debit issue. However the City's recent downgrades and current negative outlook, combined with its liquidity issues add downward pressure on Burlington Electric's rating.

MANAGEMENT NEEDS TO MITIGATE ITS EXPOSURE TO MARKET PRICES

The department is connected directly to the Vermont Electric Power Company ("VELCO") transmission grid by two 50 MW substations as well as through a 33 MW substation connected to a 34.5 Kv line jointly owned with Green Mountain Power. The Department has a 50% joint ownership share of the McNeil Station and wholly owns one gas turbine facility. Both generating stations are located within the city's limits. The McNeil station has a diversity of fuel sources with the capability of burning wood chips, natural gas and oil. McNeil operates at 50-60% capacity factor range and provides about 40% of the department's load at this capacity.

The Burlington Gas Turbine is fired by fuel oil and is used primarily to meet peak loads. Since the implementation of the ISO-NE wholesale markets rules in 1999, the unit has been run more frequently.

Burlington utility department also relies heavily on purchase power contracts for its energy supply. The years 2008 and 2009 were difficult for the department mainly because of the expiration of two favorable contracts (Northeast Utility and New York State Electric and Gas). The replacements of these contracts and short term purchases at generally higher market prices, due to the increased spot market prices, led to declining coverages.

Part of department's energy requirements is satisfied through the New England power market. Transmission expense for the year ended June 30, 2010, increased compared to 2009 primarily due to an increase in ISO NE costs for transmitting purchased power. In order to mitigate this risk, management is working on adding contracts for 2011 and onwards. Currently, the management has fixed price contracts in place of nearly 100% for 2011 and 2012, however after 2013 the department continues to be exposed to market risk and has to find more contracts to be fully protected.

FINANCIAL PERFORMANCE HAS BEEN RECOVERING DUE TO RATE INCREASE AND CAPITAL IMPROVEMENT PLANS, HOWEVER FUTURE COVERAGES REMAIN A CONCERN

The 2010 net operating revenues were 8% higher than 2009 net operating revenues. Operating income recovered in 2010 to $5.2 million after the dramatic loss of 87% in 2009. However, 2010 operating income is still lower than the 2007 figure of $8.3 million. The revenue in 2010 improved as a result of the implemented rate increases of 11.3% that went into effect on June 26, 2009 after a 22.86% increase in 2006.

The fact that the Burlington Electric Department's rates need to be reviewed and approved by PSB limits the utilities' cost recovery process. PSB has approved the department's rate increases for the last 15 years, however the low DSCR in 2008 and 2009 suggests that these rate increases should had been implemented beforehand. Moreover, the department is now above the average at 13.41 cents/kWh and is not as competitive compared to Vermont's largest two utilities, Central Vermont Public Service (12.67 cents/kWh) (preferred stock rated Ba2) and Green Mountain Power (11.89 cents/kWh) (senior secured rated Baa1) as before.

In 2008, the McNeil Generating Station (McNeil) contracted with Babcock Power to install a Regenerative Selective Catalytic Reduction (RSCR) unit. The RSCR unit significantly reduces McNeil's Nitrous Oxide (NOx) emission level which allows the station to qualify to sell Connecticut Class 1 Renewable Energy Certificated (RECs). On March 4, 2009, the Connecticut Department of Public Utilities finalized approval of McNeil Station to sell Class 1 RECs retroactive to October 1, 2008. The Department entered into agreements to sell these RECs for both the current year's generation, and for future years production. The sales are expected to be a revenue source for the department and Moody's will closely monitor the progress on this project.

With these changes, the department improved its cash and investments in FY2010. As of June 31, 2010, it had approximately $8 million compared to having less than one million in FY2009. However, the department has 63 days cash on hand for 2010, which is low compared to sector standards.

BED had approximately $18 million in reserves for 2009 and 2010, and its debt service is fully funded. The 2010 DSCR was 1.8 times and is forecasted to be 2.27 times in 2011, however coverages do not stay stable going forward. Current forecast for 2012 and 2013 DSCR is 1.75x, and unless the management puts more contracts in place, the coverage for 2014 is likely to go down to 1.26. This degree of performance volatility is a credit vulnerability.

ADDITIONAL GENERAL OBLIGATION BONDS LOWERS THE CONSOLIDATED COVERAGES

During FY2008, the department decided to issue $36 million in GO bonds to finance the cost of distribution system improvements, investment in VELCO equity at 12.%5 return, gas turbine plant improvement, and for a project to sell renewable energy through McNeil plant dispatch. The GO bonds are expected to be repaid from electric department operating revenues, but they will be subordinate to revenue bonds. In 2007, the total outstanding bonds were $65 million compared to $85 million (senior and sub) outstanding in 2010. The additional debt constrains the departments cash flow and weakens the credit quality.

KEY STATISTICS

Type of System: Electric generation and distribution

Service Area Population, 2010: approximately 39,000

Peak Demand (MW): 63.92

Average Power Supply Cost (cents/kwh): 8.323

Average Revenue per kwh: 14.078

Debt Service Coverage, 2010: 1.81x

Resource Mix, 2010: 35% owned, 65% purchased

Debt Ratio, 2010: 58.8% (of Total Assets)

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The last rating action was on March 17, 2004, when the underlying rating for Burlington Electric Department was affirmed at A3.

The bond ratings were assigned by evaluating factors believed to be relevant to the credit profile of the issuer such as i) the business risk and competitive position of the issuer versus others within its industry or sector, ii) the capital structure and financial risk of the issuer, iii) the projected performance of the issuer over the near to intermediate term, iv) the issuer's history of achieving consistent operating performance and meeting budget or financial plan goals, v) the nature of the dedicated revenue stream pledged to the bonds, vi) the debt service coverage provided by such revenue stream, vii) the legal structure that documents the revenue stream and the source of payment, and viii) and the issuer's management and governance structure related to payment.

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Outlook

Outlook

The stable outlook reflects improved debt service coverages and the managements attempts to improve the departments supply mix. Moody's will closely monitor the REC sales and other capital improvement projects impacts on the credit going forward.

What Could Change the Rating - UP

The rating could face upward pressure if rates decline substantially relative to regional competitors and the department shows stability by maintaining debt service coverage ratios at reasonable levels for a period of time through fixed priced purchase power contracts that provide security from volatile spot market prices.

What Could Change the Rating - DOWN

The rating could face downward pressure if the DSCR falls below the 1.25x rate covenant, if the department has difficulty managing the market exposure and liquidity weakens.

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