Article Title: Criteria | Governments | U.S. Public Finance: Wholesale Utilities Data: (EDITOR'S NOTE: —On Aug. 25, 2022, we republished this criteria article to make nonmaterial changes. See the "Revisions And Updates" section for details.) Wholesale utilities include gas, electric, water, sewer, and solid waste utilities that provide services to other utilities or other governmental entities, rather than to individual retail customers, such as residences and businesses. Wholesalers typically provide either system service, or project-specific service, for instance, the output of a single power plant, sewer treatment plant, or water treatment plant. In public finance, a common form of utility wholesaler is a joint action agency (JAA), which is formed with a primary mission of providing cooperative service for municipal utility systems. These agencies pool the resources and expertise of their participant municipal utility systems to achieve economies of scale. While some JAAs serve members under all-requirements contracts, JAAs will also incur project-specific debt on behalf of participating municipal utility systems for the acquisition or construction of specific utility assets, with a set apportionment of the cost and benefits of the plant. In this case, a participant's ownership interest in a project is generally defined by each participant's fixed entitlement to project output. Governing agreements typically obligate participants to unconditionally pay a pro rata share of the project's variable costs and fixed costs. In most cases, contracts governing the relationship between the wholesaler and its customers stipulate that payments to the wholesaler are considered operating and maintenance expenses, which means in the case of default, the wholesaler would be paid ahead of the bondholders or the individual customer. Nevertheless, for the purpose of gauging the credit quality of the cash flows of the wholesale utility, these operating and maintenance expenses are deemed to be of equivalent credit quality with the senior lien debt of the individual customer. The rating on a wholesale utility's debt is a function of numerous factors, including the diversity and overall credit quality of its members or customers, operational characteristics, financial strength, and legal provisions. In terms of analysis, the all-requirements or system service form of wholesale service is closer to the typical retail utility system analysis than it is to that of a project-based wholesaler. The Number Of Participants Is A Factor Wholesalers range in size from as small as three customers, to 50 or more. The precise rating approach will generally be determined by, and may vary by, the size of the wholesaler's customer base. Since a debt-issuing wholesale utility is reliant on the ability of its customer base to pay all operating costs plus debt service, the credit quality of a wholesale utility's participants (whether they are considered members or customers) will impact the wholesale utility's credit quality to varying degrees. If a wholesaler is made up of 10 or fewer participants, and there are no contractual provisions that require non-defaulting members or customers to increase their payments to account for such delinquency, then S&P; Global Ratings will employ a weak-link approach to the analysis. This is because the failure by a single participant to fulfill its payment obligations to the wholesaler would result in a project deficiency, thereby exposing bondholders to the credit quality of the project's weakest participant. In cases where a wholesale utility has about 10-25 members, there may be certain additional factors that allow the wholesale utility's credit rating to move up or down from its customers' or members' credit quality. These factors include the project operating history; attractiveness of the system's unit costs; consistently high debt service coverage, which is uncommon for wholesalers; or the level of reserves typically carried by the wholesaler. For example, in the case of a wholesale electric utility that operates in a competitive market, extremely high debt or weak project operating performance could drag the wholesaler's credit rating to a level below that of its customers. Conversely, a power plant that has consistently demonstrated a low-variable and low-fixed cost may be able to recover its costs through bilateral or spot market transactions with entities that are not members or customers, enabling the wholesaler's credit rating to float above that of its constituents. Wholesale utilities with more than 25 members or customers, assuming there is not undue concentration among a very small group of customers, can be expected to exhibit sufficient diversity to allow for a more system-oriented approach. Factors such as debt service coverage, equity in the form of unrestricted cash and investments, and overall economic considerations will become more prominent in the credit analysis, similar to the analysis of municipal retail utility providers. Wholesalers of this type do not generally have limited step-up language in their governing agreements. Take-Or-Pay Contracts Versus Take-And-Pay Contracts Wholesale utility customer relationships are governed by two types of financing agreements: take-or-pay (TOP) contracts and take-and-pay (TAP) contracts. Contracts with TOP obligations (i.e., hell-or-high-water contracts) require participants to make full revenue payments sufficient to cover debt service and operating expenses regardless of a project's operational performance or level of service used by individual participants. As such, ratings for wholesale entities with TOP provisions rely more heavily on the credit quality of the participants than do TAP projects whose financial profile is heavily influenced by project economics and performance or participant use. Although the importance of the project's operating performance is diminished with TOP payment provisions, a project's operations may still affect the project's rating, but only when project's economics make market participation a viable response to a member default. In the case of contracts that require participants to make TAP payments, participant use, and/or the strength of a project's operations plays a key role. Under a TAP arrangement, participant obligations are contingent on the adequate operating performance of the project, or on each member's quantity of service consumed. A poor operating history, projected operating difficulties, or volatile participant demand patterns could have negative implications for credit quality. Step-Up Provisions Many wholesale utilities include step-up provisions, whether implicit or explicit, in their customer or member contracts. Step-up provisions generally call for non-defaulting members to step-up, or increase, their original allocation of the project in the event of a member default. To the extent that a member's credit profile remains above that of the weakest participant after considering its contingent obligation to increase its share of the project's costs to cover the obligations of the weaker member, the presence of step-up provisions would add strength to a wholesaler's credit profile. This is because step-up provisions partially insulate the project sponsor from its weaker project participants in the event one or more of them should default. The implied step-up is accomplished through contract language that suggests the wholesale utility may increase rates to project participants in an amount sufficient to cover all of its costs. Implied step-up provisions are by their nature, unlimited, meaning that the wholesaler is free to adjust its rates in response to deviations from projected levels of revenues and expenses. In other words, should a participant fail to meet its financial obligations to the wholesaler, the wholesaler can recoup defaulted payments from non-defaulting participants without restriction by revising its budget. It is possible that the wholesaler's rating could rise to levels matching that of the strongest participants if the strongest participants could incur the entire obligations of all weaker members in amounts dictated by the step-up provision. Often, however, this amount of contingent obligation would alter a participant's leverage position to a point where it would be unable to maintain its rating. In this case, the wholesale rating would fall to the level of the strongest participant ratings after recognizing these potential downward pressures. Alternatively, explicit step-up provisions typically indicate an upper limit, expressed as a fixed percentage, of how much additional responsibility relative to its initial project share that each participant would be required to make up for the defaults of others. Explicit step-up percentages are usually within the 20% to 35% range, which usually limits the number of weaker participants that can be reviewed less rigorously when considering the wholesale rating. For projects with limited step-up provisions and a small number of participants, the credit quality of all participants must be assessed, taking into consideration each participant's ability to deliver on the full-specified step-up. By taking into account the cumulative stepped up share size of the most creditworthy participants, the impact of the weakest participants on the overall project's rating is diminished. For example, for a transaction with an explicit and limited step-up of 25%, participants whose original shares totaled only 80% of the total project could provide full support for the rating because their maximum step-up, 25% of 80%, would yield enough for 100% coverage of project costs under this methodology. The weakest 20% could thus be subject to reduced analytic scrutiny in determining the project's rating. Revisions And Updates This article was originally published on May 24, 2005. Changes introduced after original publication: Following our periodic review completed on March 16, 2016, we updated the contact information and the criteria references in the "Related Criteria And Research" section. In addition, we clarified the scope of these criteria and deleted the "Senior And Subordinated Lien" section, which was fully superseded by the article titled "Assigning Issue Credit Ratings Of Operating Entities," published on May 20, 2015. Following our periodic review completed on March 14, 2017, we updated the contact information. Following our periodic review completed on March 9, 2018, we added the "Revisions And Updates" section, updated a criteria reference, and updated the contact information. On April 23, 2019, we republished this criteria article to make nonmaterial changes. We updated a criteria reference and the contact information. On Aug. 25, 2022, we republished this criteria article to make nonmaterial changes. We updated criteria references and the contact information. Related Criteria And Research Related Criteria U.S. Municipal Water, Sewer, And Solid Waste Utilities: Methodology And Assumptions, April 14, 2022 Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021 U.S. Municipal Retail Electric And Gas Utilities: Methodology And Assumptions, Sept. 27, 2018 Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015 Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011 Principles Of Credit Ratings, Feb. 16, 2011