INFRASTRUCTURE AND PROJECT FINANCE

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SECTOR IN-DEPTH
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Regulated Electric and Gas Utilities – US

Delays in fuel cost recovery pressuring utility credit quality

Summary

» **Utilities with significant share of natural gas in their generation portfolios are vulnerable to larger deferrals.** Vertically integrated electric utilities that generate a significant amount of their power from natural gas plants are contending with much higher fuel costs this year. The sharp increase in natural gas prices that began in the second half of 2021 has led to a substantial increase in under-recovered fuel cost balances for many utilities, with the financing of those balances amounting to as high as 10% of total debt for some issuers as of 30 June. We expect to see continued high deferred fuel expenses at these companies.

» **Fuel cost recovery will likely be over a longer period and amid added regulatory scrutiny.** More regulators are likely to extend fuel cost recovery periods to between 18 and 36 months, up from the typical 12 months, to ease the impact on customer electricity rates. Regulators in some states have already extended fuel recovery periods for various utilities, with such extensions sometime proposed by the utilities themselves. While fuel costs are unlikely to be disallowed, there may be cases where regulators ask for a prudence review as such costs become more significant.

» **Utilities will issue debt to finance under-recovered fuel costs, with securitization an option if costs get too high.** Companies need to finance under-recovered fuel costs, leading to incremental debt and pressuring financial metrics and liquidity positions at a time when there are other cost pressures facing these organizations. While we typically view changes in deferred fuel balances that are expected to be recovered in the near term as a short-term factor that does not affect cash flow from operations excluding changes in working capital, the incremental debt would be credit negative if it is in place for a longer period of time.

» **Some utilities are taking measures themselves to reduce impact on customer bills.** Social risks for the US regulated electric utility sector are rising as a result of higher energy bills stemming from high natural gas prices. Some utilities are working with regulators to better manage social risks associated with the affordability of customer bills as they seek to recover higher fuel costs. Utilities will continue to use energy commodity derivatives to hedge against exposure to rising costs for purchased power, fuel for generation and natural gas for customers. In addition, some companies may use existing regulatory liabilities to offset the impact of fuel costs on customer bills.

Utilities with significant share of natural gas in their portfolios are vulnerable to larger deferrals

If natural gas prices remain high, regulated US electric utilities will likely face extended recovery periods for their elevated fuel costs as state regulators seek to mitigate the impact of such costs on customer bills. This would be credit negative for these utilities because they will likely have to finance under-recovered fuel costs with incremental debt. Hedges, more frequent fuel cost recovery filings and the potential to offset regulatory assets with regulatory liabilities could help utilities limit the overall increase in deferred fuel balances. Uncertainty about the timely recovery of purchased power and fuel costs is one of the key considerations driving our negative outlook on the US regulated utilities sector (see 2023 outlook negative due to higher natural gas prices, inflation and rising interest rates).

Exhibit 1

High natural gas prices lead to higher deferred fuel balances for US regulated utilities

Average monthly Henry Hub natural gas spot price per million British thermal units

Forecast prices as of 8 November 2022

Sources: US Energy Information Administration and SNL Market Intelligence

Vertically integrated electric utilities that generate a significant amount of their power from natural gas plants are the most vulnerable to higher fuel costs. US regulated utilities have fuel adjustment clauses that enable them to recover prudently incurred fuel costs, usually over the course of a year. Fuel costs are pass-through costs to customers and are generally fully recoverable through a fuel adjustment mechanism. Most rated vertically integrated utilities reset their fuel cost adjustment factors annually. The sharp increase in natural gas prices that started in the second half of 2021 has led to an increase in under-recovered fuel cost balances for many utilities, with the financing of those balances amounting to as high as 10% of total debt for some issuers as of 30 June.

Exhibit 2

US regulated utilities with significant gas-fired capacity are vulnerable to larger fuel cost deferrals

Company	State	Credit Rating	Outlook	Natural gas operating capacity %	Deferred fuel cost balance ($ million)		% of debt as of 30 June 2022	LTM CFO Pre-W/C to Debt
					2Q2022	FYE 2020		
Nevada Power Company	Nevada	Baa1	Stable	100%	386	39	12%	23.2%
Public Service Company of Oklahoma	Oklahoma	Baa1	Stable	72%	315	30	11%	13.9%
Entergy Mississippi, LLC	Mississippi	Baa1	Positive	88%	247	(15)	10%	19.1%
Appalachian Power Company	Virginia & West Virginia	Baa1	Stable	19%	513	5	9%	17.6%
Duke Energy Florida, LLC.	Florida	A3	Stable	75%	748	4	8%	21.4%
Sierra Pacific Power Company	Nevada	Baa1	Stable	74%	91	22	7%	19.0%
Entergy Texas, Inc.	Texas	Baa2	Stable	93%	189	(85)	7%	20.4%
Oklahoma Gas & Electric Company	Oklahoma & Arkansas	A3	Stable	74%	272	(29)	7%	23.3%
Southwestern Electric Power Company	Louisiana & Arkansas & Texas	Baa2	Stable	42%	286	3	7%	15.1%
Virginia Electric and Power Company	Virginia & North Carolina	A2	Stable	48%	1,129	(112)	6%	19.2%
Georgia Power Company	Georgia	Baa1	Stable	41%	948	(113)	6%	14.2%
Duke Energy Indiana, LLC.	Indiana	A2	Stable	42%	297	9	6%	21.8%
Duke Energy Carolinas, LLC	North Carolina & South Carolina	A2	Stable	27%	814	42	6%	23.0%
Arizona Public Service Company	Arizona	A3	Negative	56%	391	193	6%	17.7%
Tampa Electric Company	Florida	A3	Negative	80%	239	22	5%	21.3%
Entergy Louisiana, LLC	Louisiana	Baa1	Negative	76%	581	170	5%	9.6%
Florida Power & Light Company	Florida	A1	Stable	78%	1,106	94	5%	31.6%
Tucson Electric Power Company	Arizona	A3	Stable	61%	103	23	4%	24.7%
Cleco Power LLC	Louisiana & Mississippi	A3	Stable	66%	93	28	4%	10.6%
Dominion Energy South Carolina, Inc.	South Carolina	Baa2	Positive	59%	202	(56)	4%	15.1%
El Paso Electric Company	Texas & New Mexico	Baa2	Stable	71%	73	13	4%	13.7%
Entergy Arkansas, LLC	Arkansas	Baa1	Positive	41%	180	15	4%	18.0%

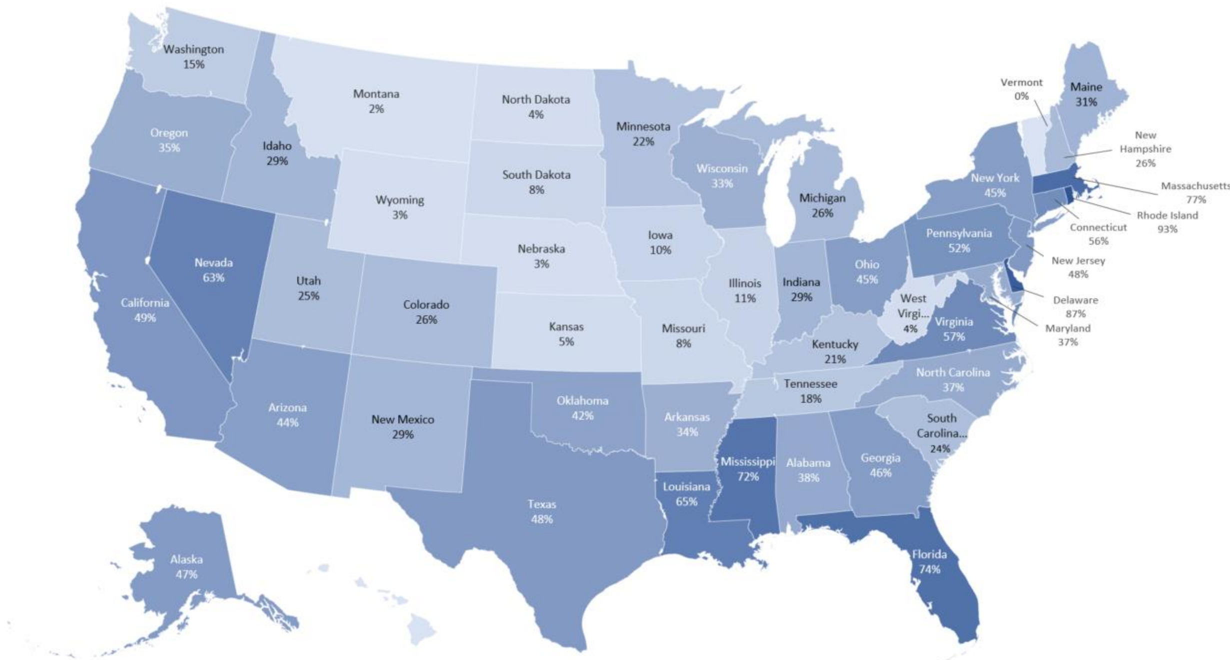
Deferred fuel costs balances do not include gas cost adjustment (GCA) balances.
All ratios are based on "adjusted" financial data and incorporate Moody's global standard adjustments for nonfinancial companies but do not reflect adjustments related to securitization.
Red and green shading represent CFO pre-WC to debt ratio below or above downgrade threshold, respectively.
Source: SNL Market Intelligence, companies filings and Moody's Financial Metrics

Fuel cost recovery likely over a longer period and amid added regulatory scrutiny

More regulators are likely to extend fuel cost recovery periods to between 18 and 36 months, up from the typical 12 months, to ease the impact on customer electricity rates. While some fuel rate adjustment proceedings are currently pending, regulators in some states have already extended fuel recovery periods to 36 months for Virginia Electric and Power Company (VEPCO, A2 stable); 24 months for Oklahoma Gas & Electric Company (OG&E, A3 stable)[1], Entergy Mississippi LLC (Baa1 positive) and Duke Energy Carolinas LLC (A2 stable) (in South Carolina); and 18 months for Tucson Electric Power Company (A3 stable). As shown in Exhibit 3, gas-fired power plants in accounts for about 57% of total generation in Virginia, 42% in Oklahoma, 72% in Mississippi, 24% in South Carolina and 44% in Arizona.

Most utilities will maintain credit supportive regulatory relationships and we expect them to eventually recover their higher fuel costs over time. While fuel costs are unlikely to be disallowed outright, there may be cases where regulators ask for a prudency review of fuel costs as they become more significant. In October, for example, the Oklahoma Corporation Commission required a review of OG&E's fuel cost rider rate increase, which had been approved earlier this year and was expected to support a 24-month recovery period for $424 million of fuel costs.

Exhibit 3
Ten states derive more than half of their power generation from natural gas
Percentage of total power generation derived from natural gas-fired plants by state in 2021



Source: US Energy Information Administration

Utilities will issue debt to finance under-recovered fuel costs, with securitization an option if costs get too high

Companies need to finance under-recovered fuel costs, which will result in incremental debt, pressuring financial metrics and liquidity positions at a time when there are other cost pressures facing these organizations. While we typically view changes in deferred fuel balances that are expected to be recovered in the near term as a short-term factor that does not affect cash flow from operations excluding changes in working capital, the incremental debt would be credit negative if it is in place for a longer period of time. In addition, there is a possibility that some regulators will not approve the recovery of incremental interest expenses related to this debt, which would hurt operating cash flow.

For example, the Virginia State Corporation Commission did not approve VEPCO's request to recover $27.5 million of financing costs related to debt issued to address an increase in fuel costs. If deferred fuel balances continue to increase and become substantial, some companies may consider using securitization to finance them, which will enable them to receive an upfront payment associated with the future recovery of fuel costs, while lessening the impact of cost recovery on customer bills. This was done by several utilities in the Texas region following the severe February 2021 Winter Storm Uri.

At the moment, transmission and distribution (T&D) companies and natural gas local distribution companies (LDCs) do not have significant deferral balances due to their hedging strategies and more timely mechanisms to recover gas costs at LDC's generally. However, LDC's face the risk of a material increase in their deferred costs during the peak winter season.

Some utilities are taking measures themselves to reduce the impact on customer bills

Social risks for the US regulated electric sector are rising as a result of higher energy bills stemming from high natural gas prices. Some utilities are working with regulators to better manage social risks associated with the affordability of customer bills as they seek recovery of higher fuel costs. Utilities will continue to use energy commodity derivatives to hedge against exposure to rising costs for purchased power, fuel for generation and natural gas for customers. In addition, some companies may use existing regulated liabilities to offset the impact of fuel costs on customer bills. For instance, Alabama Power Company (A1 stable) reduced its under-recovered fuel balance with a $126 million rate stabilization and equalization refund with the remaining $55 million refunded back to customers in July. Entergy Mississippi is offsetting a fuel costs increase with a $200 million refund from its June settlement with the Mississippi Public Service Commission regarding a rate dispute involving Entergy Corporation's (Baa2 negative) Grand Gulf Nuclear Station.

Some utilities may delay their fuel cost recovery filings themselves to mitigate increased social risks. For example, Florida investor-owned utilities Florida Power & Light Company (A1 stable), Duke Energy Florida LLC. (A3 stable) and Tampa Electric Company (A3 negative) notified the Florida Public Service Commission in April that they continue to face higher-than-expected fuel costs. However, none of the utilities requested a "mid-course correction" from the Florida PSC at that time, which could have allowed them to pass along the increased costs to customers in the subsequent months. In September, Florida utilities filed petitions proposing an increase of their 2023 fuel cost recovery factors but left open the possibility of requesting recovery of the 2022 under-recovered fuel costs in the future.

Appendix

Exhibit 4

Many utilities with significant deferred balances have moderately negative credit exposure to demographic and societal trends related to affordability concerns

ESG credit impact scores, social issuer profile scores and social risk category scores for select US regulated utilities with significant deferred fuel cost balances

Company	Credit impact score (CIS)	Social issuer profile score	Customer Relations	Demographic & Societal Trends	Financial Strategy & Risk Management
Nevada Power Company	CIS-3	S-3	2	3	1
Public Service Company of Oklahoma	CIS-3	S-3	2	3	2
Entergy Mississippi, LLC	CIS-3	S-3	2	3	2
Entergy Texas, Inc.	CIS-3	S-3	2	3	2
Oklahoma Gas & Electric Company	CIS-3	S-3	2	3	2
Virginia Electric and Power Company	CIS-3	S-3	2	3	2
Arizona Public Service Company	CIS-3	S-4	3	4	2
Tampa Electric Company	CIS-3	S-3	2	3	2
Entergy Louisiana, LLC	CIS-3	S-3	2	3	2
Florida Power & Light Company	CIS-3	S-3	2	3	2
Cleco Power LLC	CIS-3	S-3	2	3	2
Dominion Energy South Carolina, Inc.	CIS-3	S-3	2	3	2
El Paso Electric Company	CIS-3	S-3	2	3	2
Entergy Arkansas, LLC	CIS-3	S-3	2	3	2

Credit impact scores and issuer profile scores indicate credit exposure to ESG considerations. The scores are based on five-point scale where 1 is positive, 2 is neutral-to-low, 3 is moderately negative, 4 is highly negative and 5 is very highly negative.
Source: Moody's Investors Service

Moody's related publications

Sector research

» Regulated Electric and Gas Utilities – US: Inflation, high natural gas prices complicate prospects for supportive rate increases, 11 November 2022

» Regulated Electric and Gas Utilities – US: California utility wildfire mitigation efforts have reduced liability exposure, 10 November 2022

» Regulated Electric and Gas Utilities – US: 2023 outlook negative due to higher natural gas prices, inflation and rising interest rates, 10 November 2022

» Regulated Electric Utilities – US: Environmental risks drive capital spending increases, pressuring credit quality, 3 November 2022

» Regulated Electric Utilities – US: Regulatory support, storm cost recovery provisions to mitigate Hurricane Ian impact, 30 September 2022

» Regulated Electric and Gas Utilities – US: High natural gas prices, inflation and rising interest rates increase social risk, 13 June 2022

» Regulated Electric and Gas Utilities – US: 2022 outlook stable on sustained regulatory support for robust investment cycle, 4 November 2021

» Regulated Electric and Gas Utilities – US: FAQ on the growing use of securitization bonds by investor-owned regulated utilities, 4 November 2021

» Regulated Electric and Gas Utilities – Global: ESG considerations have an overall credit negative impact on utilities with generation, 1 June 2021

» Regulated Electric and Gas Utilities – US: Storm costs in south-central US are credit negative for region's regulated utilities, 5 March 2021

» Regulated Electric Utilities – US: High holdco debt limits Financial flexibility, heightens vulnerability to external shocks, 23 February 2021

» Regulated Electric and Gas Utilities — US: Latest political intervention into regulatory oversight is credit negative for New York utilities, 13 November 2020

» Regulated Electric & Gas Utilities – North America: Shifting environmental agendas raise long-term credit risk for natural gas investments, 30 September 2020

» Regulated Electric, Gas and Water Utilities – US: Coronavirus outbreak delays rate cases, but regulatory support remains intact, 6 April 2020

» Regulated electric and gas utilities – US: Grid hardening, regulatory support key to credit quality as climate hazards worsen, 2 March 2020

Endnotes

1 The 24-month recovery period was contested and could result in an extended recovery period pending commission decision.

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