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SECTOR COMMENT
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Regulated Electric, Gas and Water Utilities - US

Utilities demonstrate credit resilience in the face of coronavirus disruptions

The US regulated utility sector is better positioned than many industries to withstand the economic fallout from the coronavirus (COVID-19) outbreak. In addition to benefiting from stable residential customer demand, utilities can rely on a variety of cost recovery tools provided by state regulators, which helps to maintain a resilient financial profile through crises.

Financial market volatility is the biggest risk for utilities because the sector requires external capital in order to meet sizeable liquidity deficits. While we expect utilities to retain generally unfettered access to the capital markets, the continued spread of the virus and mounting pressures on commercial and industrial customers could ultimately weigh on utility credit quality.

Electric, gas and water utilities provide an essential public service, ensuring a base level of demand amid what has become a global pandemic. Residential customers account for roughly 35% of rated US electric and gas utility demand, which contributes to a dependable foundation of revenue. Water utilities typically have even higher residential exposure. For example, American Water Works Company Inc. (Baa1 stable), the largest investor-owned water utility in the US with utility operations across 15 states, sells about half its volume and generates about half of its revenue from residential customers.

Moreover, state regulatory commissions provide utility companies with a suite of credit supportive cost recovery tools. Mechanisms like revenue decoupling help ensure adequate fixed cost recovery regardless of changes in volumes, while a variety of capital spending trackers (including multiyear rate plans) help recoup cash outlays in a more timely manner. These features should enable utilities to maintain a base level of financial support, even amid potential declines in customer demand and economic stress for other sectors.

Financial market volatility is the most material risk, but market access still strong

The utility sector is significantly free cash flow negative and has serial debt maturities in the billions of dollars every year. For instance, about $41 billion of outstanding long-term debt is due during the remainder of 2020. As a result, utilities require continual and generally unfettered market access to maintain adequate liquidity. Exhibit 1 illustrates the aggregate sources and uses of liquidity for 40 regulated utility holding companies as of the latest reported financial data.

Exhibit 1

Holding companies have insufficient liquidity sources to meet cash demands

US regulated utility holding companies' aggregate sources and uses of liquidity, as of most recent LTM available ($ millions)

	HoldCo Totals
Credit Facility	106,258
Outstanding	26,621
Available	*79,636*
Cash	12,280
CFO	95,655
Organic sources	*107,935*
Total Sources	187,571
Capex	122,886
Dividends	29,593
Organic uses	*152,480*
Maturities (STD + CPLTD)	76,050
Total Uses	228,529
Sources - Uses	**(40,958)**

Aggregate figures for 40 holding companies

Sources: Company SEC filings and Moody's Investors Service

For most utility holding companies, high capital spending and dividend payout ratios that average 75% are outstripping cash flow generation and revolver availability. This is a credit weakness compared to other corporate sectors that produce free cash flow and generally have lower dividend requirements. As such, utilities' heavy reliance on market access is a risk at a time of financial market volatility.

However, the sector has continued to enjoy strong market access to date because it is often the sector that is most favored by investors in times of stress. In fact, utilities are typically the last to lose market access and are often the first to reopen markets. Exhibit 2 is a list of select utility and holding company bond issuances that have taken place as COVID-19 fears have escalated. The sector's favorable financing terms have been demonstrated by Duke Energy Indiana LLC's (A2, stable) recent 30-year $550 million first mortgage bond issued at 2.75%. Despite spreads widening versus benchmark US Treasury yields, an all-in lower cost of capital is beneficial to credit ratios.

Exhibit 2

Debt market transactions have remained active for utilities, despite wider spreads against benchmark Treasuries
Select US regulated utilities' debt market transactions since February

Issuer (rating, outlook)	Transaction complation date	Issuance type	Transaction value ($M)	Maturity year	Interest rate	Spread to Treasury (bps)
Union Electric Company (Baa1, stable)	17-Mar-2020	First mortgage bonds	$465	2030	2.95%	200
Consumers Energy Company (A3, stable)	17-Mar-2020	First mortgage bonds	$575	2051	3.50%	200
Dominion Energy, Inc. (Baa2, stable)	17-Mar-2020	Senior unsecured	$350	2027	3.60%	275
Dominion Energy, Inc. (Baa2, stable)	17-Mar-2020	Senior unsecured	$400	2025	3.30%	265
Entergy Arkansas, LLC (Baa1, stable)	13-Mar-2020	First mortgage bonds	$100	2028	4.00%	175
Ohio Power Company (A2, negative)	13-Mar-2020	Senior unsecured	$350	2030	2.60%	170
Duke Energy Indiana (A2, stable)	10-Mar-2020	First mortgage bonds	$550	2050	2.75%	165
Entergy Texas (Baa3, positive)	5-Mar-2020	First mortgage bonds	$175	2049	3.55%	138
Southern California Edison (Baa2, stable)	4-Mar-2020	First mortgage bonds	$400	2030	2.25%	125
American Electric Power (Baa1, negative)	3-Mar-2020	Senior unsecured	$400	2050	3.25%	165
American Electric Power (Baa1, negative)	3-Mar-2020	Senior unsecured	$400	2030	2.30%	130
Entergy Louisiana (Baa1, stable)	3-Mar-2020	First mortgage bonds	$350	2051	2.90%	130
Commonwealth Edison (A3, stable)	18-Feb-2020	First mortgage bonds	$650	2050	3.00%	100
Commonwealth Edison (A3, stable)	18-Feb-2020	First mortgage bonds	$350	2030	2.20%	68
FirstEnergy Corp. (Baa3, stable)	18-Feb-2020	Senior unsecured	$850	2050	3.40%	140
FirstEnergy Corp. (Baa3, stable)	18-Feb-2020	Senior unsecured	$600	2030	2.65%	110
FirstEnergy Corp. (Baa3, stable)	18-Feb-2020	Senior unsecured	$300	2025	2.05%	70
DTE Electric (A2, stable)	11-Feb-2020	First mortgage bonds	$500	2050	2.95%	90
DTE Electric (A2, stable)	11-Feb-2020	First mortgage bonds	$600	2030	2.25%	68

Sources: Moody's Investors Service and SPGMI

Moreover, management teams can take mitigating steps to improve their liquidity, such as increasing external credit facilities, trimming capital spending or reducing their large dividend payments. Of these defensive levers, we see the addition of liquidity facilities as the most likely to be used because utilities benefit from a flight to quality on the part of investors and these facilities can be a low-cost option that maintains equity investor-friendly financial policies of capital and dividend growth.

Trimming capital spending is likely the next best alternative for management because some capital can be scaled back and deferred to a later date without any risk to safety or service reliability. We estimate that cutting sector capital expenditures to maintenance levels would likely provide enough liquidity to support most utility's cash needs. This could be important if COVID-19 and recessionary pressures limit capacity of the financial markets to absorb corporate issuance needs.

And while dividend cuts have been exercised in the past, this is usually a last resort for management and often indicates that greater risks are on the horizon. In fact, holding companies in the sector increased dividends in both 2008 and 2009, at a compound annual growth rate (CAGR) of more than a 5%, despite the recession and the financial crisis.

Most direct risk is declining commercial and industrial demand

Sales to commercial and industrial (C&I) customers, which account for about 50% of electric revenue, are far more vulnerable to economic disruptions than residential demand. In addition, such customers may not always be included as part of decoupling mechanisms, or pay a high fixed-charge demand fee, and thus could be a source of potential volatility for utility sales.

From a distribution perspective, local gas distribution companies and large investor-owned water companies are least likely to be affected by declines in C&I demand because those classes represent around 19% for gas companies and less than 30% of revenue for both American Water and the water segment of Essential Utilities Inc. (Baa2 stable), formerly known as Aqua America Inc.

Interstate electric transmission assets and companies are perhaps the best positioned overall because their rates are set based on a formulaic, forward-looking rate-setting mechanism, with a monthly formula that adjusts for changes in network load that impacts demand. This should benefit primarily transmission companies like New England Power Company (A3 positive) and Central Maine Power Company (A2 stable), or even companies like Public Service Electric and Gas Company (A2 stable) and NSTAR Electric Company (A1 stable), which have rate bases that are comprised of about 45% interstate transmission assets.

Among the utility sector's largest industrial customers are oil and gas companies, which are also suppliers of fuel to utilities. Upstream producers can even be a source of demand for water utility companies that deliver water for fracking. In the wake of the COVID-19 outbreak, which is reducing demand, oil producers are enduring plummeting share prices, a rising cost of debt and a sharp decline in oil and gas prices, which has been exacerbated by the supply shock that emerged out of the disagreement among the producing country members of OPEC in March 2020. If these pressures were to weaken credit quality in the energy sector, utility demand could be negatively affected.

Also, holding companies owning natural gas pipelines that have a supply-push orientation (i.e., shippers seeking to sell gas) will be more at risk for credit degradation than those with a utility demand-pull (i.e., shippers requiring gas to serve end-use customers) customer profile.

Exhibit 3

Utilities in South, Midwest rely most heavily on industrial customers

States where utilities with highest industrial exposure operate

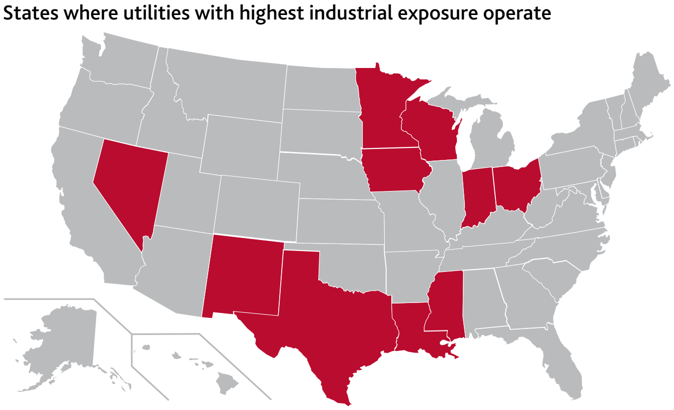

Exhibit 4

ALLETE and Superior are most exposed to industrial customers

Top 10 utilities with highest proportion of industrial customers

Company	Rating, Outlook	State	% Industrial customers (by MWh volumes)
ALLETE, Inc.	Baa1, Stable	Minnesota, Wisconsin	74%
Superior Water, Light and Power Company	A3, Stable	Wisconsin	73%
Toledo Edison Company	Baa1, Stable	Ohio	57%
Southwestern Public Service Company	Baa2, Stable	New Mexico, Texas	55%
Northern Indiana Public Service Company	Baa1, Stable	Indiana	54%
MidAmerican Energy Company	A1, Stable	Iowa	52%
Entergy Louisiana, LLC	Baa1, Stable	Louisiana	52%
Mississippi Power Company	Baa2, Positive	Mississippi	50%
Indianapolis Power & Light Company	Baa1, Stable	Indiana	47%
Sierra Pacific Power Company	Baa1, Stable	Nevada	47%

Electric volumes as of year end 2018.

Source: Moody's Investors Service, SPGMI

Utility business model and financial profiles are resilient

During previous economic downturns, utilities have exhibited a strong track record of generating enough revenue to cover their costs and earn a profit. For example, during the 2008-09 financial crisis, the gross margin and cash flow for approximately 40 large electric and gas utility holding companies continued to increase year-over-year despite the economic recession and pressures on volume consumption of electricity and natural gas. Thanks to authorized recovery mechanisms, such as revenue decoupling and others, funds from operations increased by nearly 12% CAGR 2007-2009.

Along the same lines, Essential Utilities, a large investor-owned water utility holding company, steadily increased its revenue, net income and cash flow from operations year-over-year, with CAGRs of around 6%, 5% and 16%, respectively.

Maintaining financial cushion is best action to avoid negative credit implications associated with unforeseen events, such as a protracted downturn or counterparty weakness

If a failure to contain the COVID-19 outbreak leads to more severe economic repercussions, some utility companies would be more vulnerable than others. Those with weak financial metrics for their current credit profile, like Sempra Energy (Baa1 negative) and Duke Energy Corporation (Baa1 stable) will have little to no financial flexibility to withstand any form of financial challenges without taking mitigating measures.

For utility holding companies that own midstream assets, such as natural gas pipelines, significant revenue and volume exposure to financially weakened oil and gas producers or counterparties could drag on their respective consolidated credit profiles. If a protracted recession occurs, these sectors could experience significant financial stress. CenterPoint Energy Inc. (Baa2 stable) and OGE Energy Corp. ([P]Baa1 stable) are two holding companies with material exposure to the energy sector via shared ownership of Enable Midstream Partners LP (Baa3 stable), as is DTE Energy Company (Baa2 stable), given its recent acquisition of midstream gas gathering assets in Texas.

Companies that are in the midst of large, multiyear capital plans for investments like liquefied natural gas export terminals, natural gas pipelines and offshore wind, could also be exposed if supply-chain disruptions endure or if economic volatility changes the financial and commercial premises upon which the project was founded. This could affect utility holding companies, such as Avangrid Inc. (Baa1 stable), Dominion Energy Inc. (Baa2 stable) and Duke Energy.

Moody's related publications

Outlook

- Global Macro Outlook 2020-21 (March 2020 Update): Coronavirus will hurt economic growth in many countries through first half of 2020, March 2020
- Regulated electric and gas utilities – US: 2020 outlook moves to stable on supportive regulation, weaker but steady credit metrics, November 2019

Sector In-Depth

- Regulated electric and gas utilities – US: Grid hardening, regulatory support key to credit quality as climate hazards worsen, March 2020
- Regulated electric utilities – US: Intensifying climate hazards to heighten focus on infrastructure investments, January 2020
- Regulated electric and gas utilities – New York: Threat to revoke National Grid's operating license is credit negative for utilities, November 2019
- Electric utilities and power producers – US: Power companies on pace to reduce CO2 emissions, September 2019
- Utilities and power companies – North America: Corporate governance assessments show generally credit-friendly characteristics, September 2019
- Regulated electric and gas utilities – US: Recent regulatory, legislative developments have been largely credit positive, September 2019
- Regulated electric and gas utilities - North America: Free cash flow and capital allocation: external capital needs to decline in 2019, August 2019
- Regulated electric utilities – US: Proposed California wildfire risk legislation is credit positive but questions remain, July 2019
- Electric and gas – US: Pipeline cybersecurity standards help plug security loophole in utility supply chain, July 2019
- Regulated water utilities - US: M&A expands to cross-sector deals, with mixed credit implications for acquirers, March 2019
- Regulated Utilities and Power - US: PG&E bankruptcy highlights environmental, social and governance risks in California, February 2019

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