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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.

Jul 22 2020

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.

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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 completion 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.

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.

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