The A Rating

By Steven M. Fetter

When I came to the Michigan Public Service Commission in 1987, the average regulated electric utility had a relatively solid credit rating—in the A- to BBB+ range, comfortably investment-grade—and utilities borrowed money for capital improvements rather easily. In 1992, close to 65 percent were A- or higher, and around 25 percent were in the BBB rating category. By 1998, 61 percent were A- or higher, with 31 percent in the BBB category.

Today the average rating for the sector is slightly above a BBB rating—still investment-grade, but now just 18 percent of electric companies are A- or higher, and more than 62 percent are in the BBB range.

The downward trend in utility ratings toward BBB seemed acceptable during the past decade—utilities could still borrow, relying on their regulated positions and growing demand; and dividend-paying stocks became more attractive to equity investors. It seemed that cash-flow and liquidity requirements no longer needed to be as high as for A-rated companies.

Today's capital markets, however, are experiencing a worldwide economic crisis, and the country is in severe recession. Indeed, the current economic turmoil has resulted in some utilities within the BBB category experiencing difficulty in accessing the capital markets. Even when capital is available, it is often at significantly higher costs and upon less favorable terms and conditions.

While the financial crisis has led to increases in debt and equity risk premiums for all utilities, these increases have been more consistently applied to utilities on the lower end of the credit rating scale, resulting in significantly higher cost of debt capital for BBB utilities than for A-rated ones. A December 2008 report released by J.P. Morgan, "Conservative Capital Structures: Reclaiming the Throne," opined that "generally, firms' lowest cost of capital is now reached at credit ratings that are about four notches higher than they were 18 months ago.... This trend is driven by a widening gap between the availability and costs of debt for higher and lower-rated firms." And as Garry Brown, chairman of the New York Public Service Commission says, "there is a clear relationship between a utility's bond rating and its ability to borrow at a reasonable cost, particularly in times of economic distress."

Unlike the broader industrial sector, which can delay capital investment in times of duress, electric utilities carry a responsibility to expend capital when needed to ensure safe and reliable service to customers. They do not have the option of substantially cutting back operations during difficult economic times. As Brown further notes, "Large capital programs... make it very important that electric utilities continue to have access to the financial markets, and regulatory policies should support utilities' ability to raise capital."

Flexibility in a Crisis

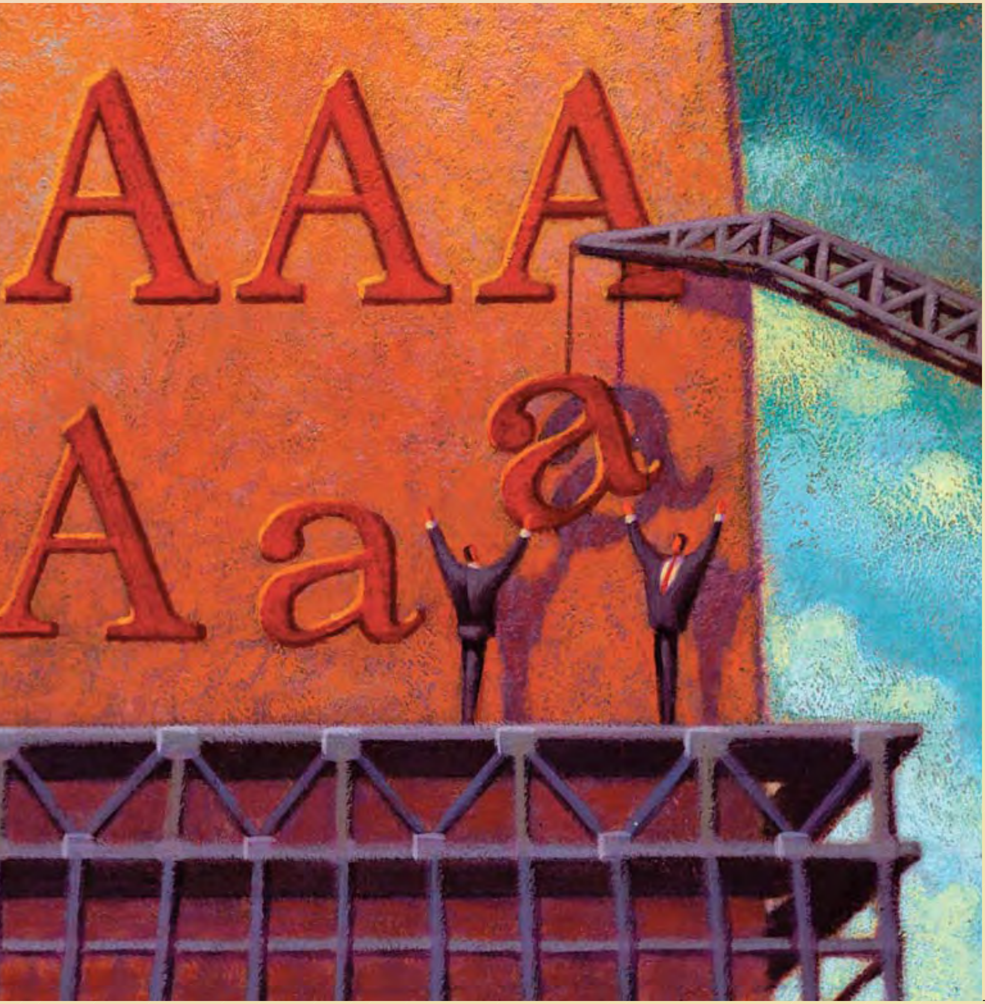
Here are two examples, admittedly extreme, that illustrate differing capabilities of an A-level utility and a BBB-level one. On September 11, 2001, Con Edison held an A+ credit rating. In the face of the terrorist events of that day, the utility was able immediately to initiate one of the largest infrastructure recovery efforts any industry has ever faced, without seeking special treatment from suppliers or lenders. The company's credit rating and outlook never stuttered as it proceeded to bring businesses in lower Manhattan back to full function.

In the other example, Entergy New Orleans had seen its corporate credit rating improve from BBB with a credit watch negative to BBB with a stable outlook. Then, in August 2005, Hurricane Katrina devastated the utility's infrastructure and customer base. Huge impacts, to be sure, but the utility also faced resistance from contractual counterparties to provide supplies and assistance. The utility soon filed for bankruptcy, allowing its parent company, Entergy Corporation, to provide $200 million in funds to support the long process of reorganization and recovery. (Entergy New Orleans emerged from bankruptcy in June 2007 with a BBB- rating.)

These examples came long before the current financial market crisis, but they demonstrate that a credit profile in the A category provides substantial flexibility for a regulated utility's management to respond to customer needs while respecting investor interests.

New Era

The discussions among executives, regulators, and Wall Street that focused on diversification in the 1980s and 1990s and industry restructuring in the 1990s and 2000s have now shifted to risk management, rate-recovery mechanisms, pre-approval, putting construction work in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The bottom line is that electric utilities must collect sufficient cash flow through rates to maintain strong credit rating metrics. This is especially true for companies needing to proceed with major generation construction, notwithstanding the negative economic environment. S&P has highlighted cash flow as the single most critical aspect of all credit rating decisions. And liquidity is the lifeblood of day-to-day utility management flexibility.

To get the right amount can be rough going. In February 2009, to bolster liquidity and support their credit ratings, Ameren Corporation and Great Plains Energy substantially cut their dividends. The result on the equity side for those companies was a drop in stock price during the subsequent month of 35-45 percent. Certainly other utilities are watching the fallout from those decisions to determine whether internal cost-cutting can serve as more than a stopgap solution to liquidity stresses or whether they will have to follow the same volatile dividend reduction path.

Still, the A rating is positive for all stakeholders within the regulatory process—lower financing costs accrue to the benefit of customers through the ratemaking process; and the lower costs serve to maintain investor support and provide a degree of flexibility to respond to unforeseeable events.

Notwithstanding the current financial crisis, many utilities need to make substantial new capital investment, including a new generation of nuclear construction, to serve forecasted load growth. As a former state regulator and bond rater, I believe the optimal strategy is for utilities and their regulators to work in concert to ensure strong cash flow. Sustained and constructive regulatory support will be a major factor in how both investors and rating agencies will perceive electric utilities during these uncertain economic times. A shared commitment to financial stability will go a long way toward allowing A-rated companies to remain at that more secure level and provide hope for others that are endeavoring to move up to it.

progress into rate base, and other means of supporting utility credit profiles during periods of substantial capital investment. That change in focus should be encouraging for state regulators. Perhaps we have returned to a time when it would be in the interest of both companies and regulators to work in concert to support stronger credit profiles for regulated electric utilities (optimally in the A category), for the good of both consumers and investors. Even a strong BBB+ rating provides a measure of downside protection from the serious ills that would accompany a utility falling below investment-grade or even dropping to borderline BBB- status.

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