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Credit Ratings: What They Are, Why They Matter

CALIFORNIA PUBLIC UTILITIES COMMISSION THOUGHT LEADERS SERIES

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Agenda

1. What Ratings Are, Why They Matter
2. How Ratings Are Produced
3. What Ratings Mean For Californians

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What Ratings Are, Why They Are Important

Ratings: What They Are, Why They Are Important

What They Are

- » Independent, objective assessments of the relative creditworthiness of debt obligations
- » Shorthand symbols denoting the relative ability and willingness of debt issuers to make full and timely payment
- » Opinions about future potential risks

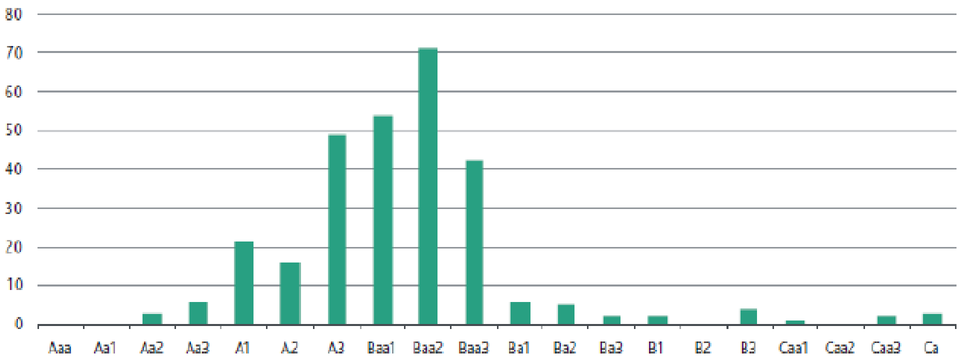
Why They Are Important for Utilities

- » Capital-intensive business requires constant debt issuance
- » Ratings make debt securities more liquid
- » Investment grade ratings provide better access to capital, lower cost of capital, lower rates for customers

Utilities Are Highly Rated

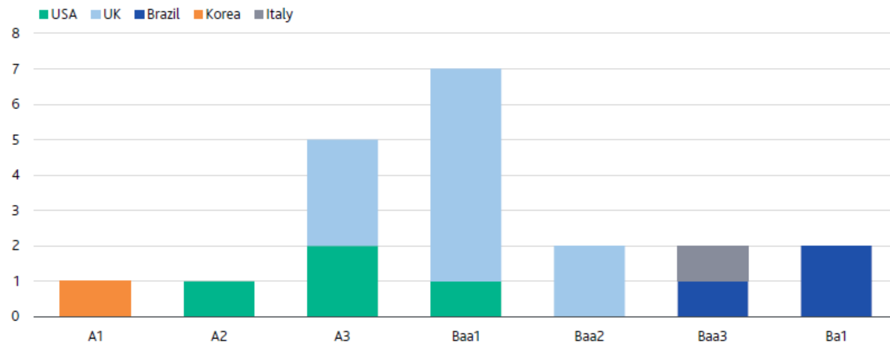
- Investment grade ratings indicate stability from regulation
- Reflect better history of default and recovery rates than those in competitive industrial sectors
- Average ratings: US utilities Baa1, water utilities A3, California utilities A2*

Global Electric & Gas Utility Ratings Distribution



Source: Moody's

Global Water Utility Ratings Distribution



*Average of San Diego Gas & Electric (A1), Southern California Gas (A1), Southern California Edison (A2), Pacific Gas & Electric (A3)

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How Ratings Are Produced

Utility Rating Methodology: Regulation Most Important

» Regulation accounts for half the rating, influences the other factors

  » Profitability, diversity dominate for unregulated competitive industries

Factor / Sub-Factor Weighting - Regulated Utilities

Broad Rating Factors	Broad Rating Factor Weighting	Rating Sub-Factor	Sub-Factor Weighting
Regulatory Framework	25%	Legislative and Judicial Underpinnings of the Regulatory Framework	12.5%
		Consistency and Predictability of Regulation	12.5%
Ability to Recover Costs and Earn Returns	25%	Timeliness of Recovery of Operating and Capital Costs	12.5%
		Sufficiency of Rates and Returns	12.5%
Diversification	10%	Market Position	5%*
		Generation and Fuel Diversity	5%**
Financial Strength, Key Financial Metrics	40%		
		CFO pre-WC + Interest/ Interest	7.5%
		CFO pre-WC / Debt	15.0%
		CFO pre-WC – Dividends / Debt	10.0%
		Debt/Capitalization	7.5%
Total	100%		100%

Factor 1A: Improvement in US regulatory environment vs. jurisdictions in other countries led to upgrades of most US utilities in 2014; A score for most and for CA*

Factor 1B: Utility-specific regulatory treatment; scores range Aa-Baa; A for most; A average fir CA*

Factor 2A: Rate case process, cost recovery mechanisms, regulatory lag; scores range Aa-Ba, A for most; Aa average for CA*

Factor 2B: ROE (allowed vs. industry average and actual earned), disallowances; scores range from Aa to Ba, Baa for most and for CA*

Factor 4: Financial metrics accounts for majority in competitive industries

Cash flow from operations before working capital changes (CFO pre-WC)-to-debt ratios most important

*Average of San Diego Gas & Electric (A1), Southern California Gas (A1), Southern California Edison (A2), Pacific Gas & Electric (A3)

Supportive Regulation Leads to Stronger Credit Metrics

- Strong factors 1B, 2A, 2B scores correlate to stronger CFO Pre WC/Debt
- California utilities average 29% CFO Pre WC/Debt

Factor 1B Consistency, Predictability of Regulation		Factor 2A Timeliness of Recovery of Costs		Factor 2B Sufficiency of Rates and Returns	
Score	**CFO Pre WC/Debt**	**Score**	**CFO Pre WC/Debt**	**Score**	**CFO Pre WC/Debt**
Aa	24%	Aa	24%	Aa	18%
A	22%	A	22%	A	23%
Baa	20%	Baa	20%	Baa	22%
Ba	15%	Ba	N/A	Ba	19%

Source: Moody's FM

- Low CFO pre WC/Debt ratio for Aa score in Factor 2B an outlier due to low-risk T&Ds that have lower but more stable returns and CFO

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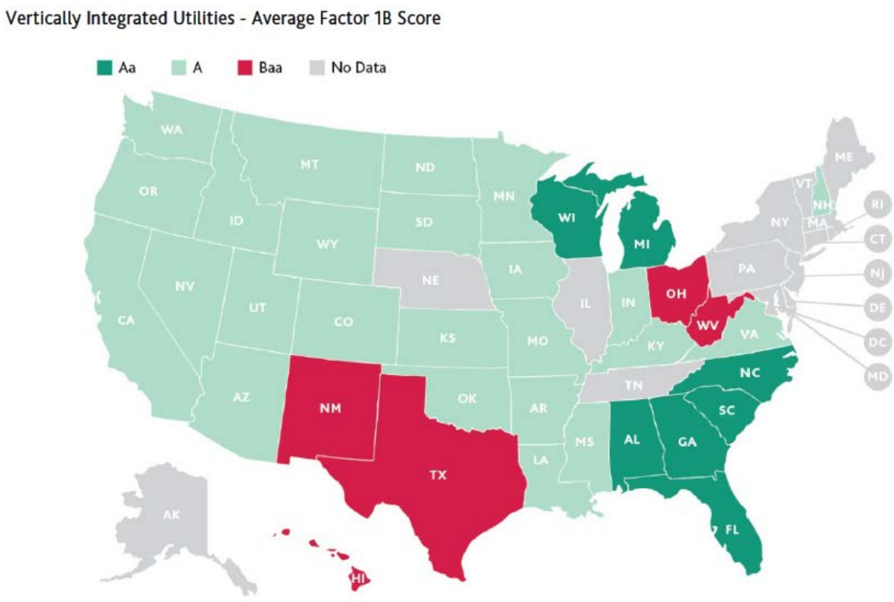
3 What Ratings Mean For Californians

Strong Ratings: Better Access to Capital at Lower Cost

- California utilities need to finance $24B of capex (2x depreciation) and refinance +$1B of maturing debt in 2015-16
- Investors and utilities make decisions on where they want to invest

Consistency, Predictability of Regulation (Factor 1B)



Source: Moody's

What Utility Ratings Mean For Californians

» California utilities need to raise large amount of capital to fund their capex

» Ratings make debt securities more liquid

» Investment grade ratings provide better access to capital, lower cost of capital, lower rates for customers

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