Ratings Methodology For Utilities

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CPUC Thought Leaders Session

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Why Did We Redesign Our Corporate Ratings Criteria?

The new criteria is intended to:

- Provide an integrated, **globally consistent framework** that is intuitive and builds upon our existing ratings methodology, which has performed well from a ratings quality standpoint.
- Offer greater **transparency** and **insight** into the ratings process.
- Facilitate better global consistency and **comparability** in determining ratings.
- Deliver ratings that are **forward-looking** and comparable across industry sectors and geographies.
- Provide **clear guidance** on how various components of analysis are utilized to determine the ultimate rating outcome.
Corporate Ratings Criteria
The Corporate Ratings Criteria Framework

Greater TRANSPARENCY
Enhanced GLOBAL COMPARABILITY
Maintains ANALYTICAL JUDGMENT

COUNTRY RISK
INDUSTRY RISK
COMPETITIVE POSITION
CASH FLOW / LEVERAGE

BUSINESS RISK PROFILE
FINANCIAL RISK PROFILE
ANCHOR

MODIFIERS
- Diversification/ portfolio effect
- Capital structure
- Financial policy
- Liquidity
- Management/ governance
- Comparable ratings analysis

STAND-ALONE CREDIT PROFILE

ISSUER CREDIT RATING

Group or government influence
Business Risk Profile

Country Risk

Industry Risk

Competitive Position

Cash Flow / Leverage

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ANCHOR
Competitive Position

- Competitive Advantage
- Scale, Scope & Diversity
- Operating Efficiency
- Level of profitability
- Volatility of profitability

Preliminary Competitive Position Score

Profitability can strengthen or weaken the competitive position

Profitability
We have updated the Competitive Position Group Profile

<table>
<thead>
<tr>
<th>Component</th>
<th>Services and Product Focus</th>
<th>Product Focus/Scale Driven</th>
<th>Capital or Asset Focus</th>
<th>Commodity Focus/Cost Driven</th>
<th>Commodity Focus/Scale Driven</th>
<th>National Industries &amp; Utilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competitive Advantage</td>
<td>45%</td>
<td>35%</td>
<td>30%</td>
<td>15%</td>
<td>10%</td>
<td>60%</td>
</tr>
<tr>
<td>Scale, Scope and Diversity</td>
<td>30%</td>
<td>50%</td>
<td>30%</td>
<td>35%</td>
<td>55%</td>
<td>20%</td>
</tr>
<tr>
<td>Operating Efficiency</td>
<td>25%</td>
<td>15%</td>
<td>40%</td>
<td>50%</td>
<td>35%</td>
<td>20%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>
The business risk profile and the financial risk profile combine to determine the issuer’s anchor.
<table>
<thead>
<tr>
<th>Business Risk Profile</th>
<th>1 (minimal)</th>
<th>2 (modest)</th>
<th>3 (intermediate)</th>
<th>4 (significant)</th>
<th>5 (aggressive)</th>
<th>6 (highly leveraged)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 (excellent)</td>
<td>aaa/aa+</td>
<td>aa</td>
<td>a+/a</td>
<td>a-</td>
<td>bbb</td>
<td>bbb-/bb+</td>
</tr>
<tr>
<td>2 (strong)</td>
<td>aa/aa-</td>
<td>a+/a</td>
<td>a-/bbb+</td>
<td>bbb</td>
<td>bb+</td>
<td>bb</td>
</tr>
<tr>
<td>3 (satisfactory)</td>
<td>a/a-</td>
<td>bbb+</td>
<td>bbb/bbb-</td>
<td>bbb-/bb+</td>
<td>bb</td>
<td>b+</td>
</tr>
<tr>
<td>4 (fair)</td>
<td>bbb/bbb-</td>
<td>bbb-</td>
<td>bb+</td>
<td>bb</td>
<td>bb-</td>
<td>b</td>
</tr>
<tr>
<td>5 (weak)</td>
<td>bb+</td>
<td>bb+</td>
<td>bb</td>
<td>bb-</td>
<td>b+</td>
<td>b/b-</td>
</tr>
<tr>
<td>6 (vulnerable)</td>
<td>bb-</td>
<td>bb-</td>
<td>bb-/b+</td>
<td>b+</td>
<td>b</td>
<td>b-</td>
</tr>
</tbody>
</table>

When two anchor outcomes are listed for a given combination of business risk profile assessment and financial risk profile assessment:

- The anchor will be based on the comparative strength of its competitive position if FRP is 4 or stronger
- The anchor will be based on the comparative strength of its cash flow/leverage if FRP is 5 or 6
Modifiers

Country Risk
Industry Risk
Competitive Position
Cash Flow / Leverage

BUSINESS RISK PROFILE

ANCHOR

MODIFIERS

Diversification/ portfolio effect
Capital structure
Financial policy
Liquidity
Management/ governance
Comparable ratings analysis

STAND-ALONE CREDIT PROFILE

ISSUER CREDIT RATING

Group or government influence

Standard & Poor’s Ratings Services
McGraw Hill Financial
Specific score and descriptors are used for these modifiers to determine the number of notches to apply to the anchor.

Rating modifier categories may raise or lower a company’s anchor score by 1 or more notches – or have no effect, in some cases.

An issuer’s anchor cannot be lowered below ‘b’ using one or more of these categories.
The Group Rating Methodology

Steps in determining an issuer credit rating (ICR) involves an assessment of:

- The group’s overall creditworthiness
- The status of an entity relative to other group members and the parent company, and
- The stand-alone credit profile (SACP) of group members

- For Government Related Entities, we also consider the potential for extraordinary government support

Potential for support or negative intervention from the parent company or group is a major rating consideration.
Utility-Specific Criteria
Regulated utilities fit into the new corporate methodology with only a few significant differences. See the KCF for all the details.

Key Credit Factors (KCF) article - major changes to the corporate methodology as applied to utilities:

- Use “Regulatory Advantage” instead of “Competitive Advantage”
- Utility-specific accounting adjustments
- When to use which ratio benchmark table

GRM: a relevant section on “insulated subsidiaries” (a/k/a “ringfencing”)
Assessing Regulatory Advantage

Regulatory stability
• Transparency / Predictability / Consistency

Tariff-setting procedures and design
• Recoverability of operating and capital costs
• Effect of Incentives

Financial stability
• Timeliness of cost recovery
• Flexibility to allow for recovery of unexpected costs if they arise
• Attractiveness of the framework to attract long-term capital

Regulatory independence and insulation
• As enshrined in law
• Risks of political intervention

More on our analysis of utility regulation in the U.S. will soon be available on our website:
Accounting Adjustments - Utilities

Purchased Power
- We may impute debt for long-term “PPAs” of integrated electric utilities
- Risk factors used to reduce the imputed amount depending on cost recovery
- Specialized situations: evergreening, lease accounting, energy-only contracts

Natural Gas Seasonal Inventory
- Short-term debt associated with pre-season inventory build-up removed from capital structure

Securitized Debt
- Debt and associated revenues and expenses deconsolidated
- Only if debt service is accorded specialized recovery, usually by statute

Infrastructure Renewals
- U.K. GAAP issue

IFRS vs. U.S. GAAP – Regulatory Accounting
We comment in the KCF that we don’t anticipate altering our analysis if regulatory accounting changes
Credit Ratio Benchmark Tables

Low-Volatility Table
• A vast majority of operating cash flows from regulated operations at the low end of the utility risk spectrum (e.g. networks)
• A “strong” regulatory advantage score
• An established track record (and expected to continue) of stable credit measures
• Demonstrated long-term track record (and expected to continue) of low funding costs
• Non-utility activities that are low risk, nonstrategic, and in a separate part of the group

Medial-Volatility Table
• That do not qualify for the ‘low volatility’ table
• At least an “adequate” regulatory advantage score
• About one-third or more of operating cash flows from regulated activities with a “strong” regulatory advantage score and remaining operations with a competitive position score of ‘3’ or higher

Standard Corporate Table
• An “adequate/weak” or “weak” regulatory advantage score
• About one-third or less of operating cash flows from regulated activities (regardless of its regulatory advantage assessment)
Group Rating Methodology – Insulated Subsidiaries

GRM does allow for rating above the “group credit profile” for regulated entities when there are unusual restrictions.

Basic elements (one notch above GCP)
- Stand-alone credit profile merits a higher rating
- Financially independent from the group and severable
- Parent has strategic and economic interest in preserving subsidiary
- Unlikely to be substantively consolidated in parent bankruptcy
- Separateness (no commingling of funds, etc.)
- Legislative, regulatory, or structural restrictions

Additional elements (two notches if one applies)
- Significant minority shareholders with active economic interest
- Independent board members with effective influence on decisions
- “Strong” restrictions coupled with active regulatory oversight or stated policy

Three notches or complete “delinking” is possible
- Refer to the GRM criteria for specifics
Thank You

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Appendix IV

Glossary of Terms:
Criteria Framework Descriptions
Glossary of Terms: Criteria Framework Descriptions

Corporate Ratings Framework
Standard & Poor’s Ratings Services’ corporate analytical methodology organizes the analytical process according to a common framework, and it divides the analysis into several categories so that all salient issues are considered. The first categories analyze the company’s business risk profile, followed by an evaluation of its financial risk profile, which we then combine to determine an issuer’s anchor rating. We then use several subsequent analytical steps to determine the ultimate rating conclusion.

Country Risk
Country risk includes the broad range of economic, political, financial-market and legal factors that can affect credit quality, which arise from doing business from or within a specific country. The credit risk for every rated entity and transaction is influenced by these types of country-specific risks.

Industry Risk
The analysis of industry risk enhances the comparability and transparency of ratings among sectors by comparing and scoring inter-industry risk. The methodology addresses the major factors that S&P Ratings believes affect the risks that entities face in their respective industries.

CICRA
CICRA is the issuer's Corporate Industry and Country Risk Assessment which is combined assessment of the pertinent industry risk and country risk for that issuer. It is the starting point for the ratings analysis based on the issuer’s industry risk categorization and country risk exposure.

Competitive Position
Competitive position encompasses the combination of company-specific business features and operating attributes that add to or mitigate its industry risk and country risk. The criteria group these features into four components: i) competitive advantage; ii) scale, scope and diversity; iii) operating efficiency; and iv) profitability.
Glossary of Terms: Criteria Framework Descriptions

**Cash Flow/Leverage**
The pattern of cash flow generation, current and future, in relation to cash obligations is often the best indicator of a company’s financial risk. The criteria guide analysts to assess a range of credit ratios, predominately cash flow based, which complement each other by focusing attention on the different levels of a company’s cash flow waterfall in relation to its obligations.

**Anchor**
The issuer’s anchor is derived from the comparative strength of an entity’s business profile when combined with its financial risk profile.

**Diversification/Portfolio Effect**
The diversification/portfolio effect criteria are used to assess the value of diversification or the portfolio effect for large corporate entities that have multiple business lines.

**Capital Structure**
The assessment of a company’s capital structure captures risks that may not arise in the standard analysis of cash flow adequacy and leverage. These risks may exist because of maturity or currency mismatches between a firm’s sources of financing and the firm’s assets or cash flows and risks in the firm’s external environment such as volatile interest rates or currencies.

**Financial Policy**
Financial policy serves to refine the view of a company’s risks beyond the conclusions arising from the standard assumptions in the cash flow/leverage, capital structure/asset protection, and liquidity analyses. The financial policy adjustment is a measure of the influence (negative, positive or neutral) that, in our view, management is likely to exert on an issuer’s financial risk profile beyond what is implied by recent credit metrics or what has already been built in cash flow and leverage forecasts.
Glossary of Terms: Criteria Framework Descriptions

Liquidity
Our assessment of liquidity analysis focuses on the monetary flows – the sources and uses of cash – that are the key indicators of a company's liquidity cushion. The analysis assesses the potential for a company to breach covenant tests related to declines in earnings before interest, taxes, depreciation, and amortization (EBITDA), as well as the ability to absorb high-impact, low-probability events, the nature of bank relationships, the level of standing in credit markets, and the degree of prudence of the company's financial risk management.

Management and Governance
The evaluation of management and governance encompasses the broad range of oversight and direction conducted by an enterprise's owners, board representatives, executives, and functional managers. Their strategic competence, operational effectiveness, and ability to manage risks shape an enterprise's competitiveness in the marketplace and credit profile.

Comparable Ratings Analysis
In the comparable ratings analysis, we take a holistic review of a company's stand-alone credit risk profile to determine its relative credit standing versus comparably rated entities. A company is generally compared and benchmarked with industry peers within the same rating category as well as with entities from other sectors within the same rating category.

Stand-Alone Credit Profile
The Stand-Alone Credit Profile (SACP) is derived from the analytical adjustments from the modifier categories on the Anchor based on the entities’ credit strengths or weaknesses.

Group or Government Influence
The adjustment to the SACP is applied in the case of group or government influence.

Issuer Credit Rating
The Issuer Credit Rating (ICR) results from the combination of the SACP and the support framework, which determines the extent of uplift, if any, for group or government influence.