S&P Global Ratings

Research

COVID-19: The Outlook For North American Regulated Utilities Turns Negative

April 2, 2020

PRIMARY CREDIT ANALYST

Gabe Grosberg

New York

(1) 212-438-6043

gabe.grosberg@spglobal.com

SECONDARY CONTACT

Kevin M Sheridan

New York

+ 1 (212) 438 3022

kevin.sheridan@spglobal.com

Key Takeaways

- We are revising our assessment of the North America regulated utility industry to negative from stable.
- We expect that the utility industry will remain a high-credit-quality investment-grade industry.
- We expect that the industry's median rating, which is 'A-', could weaken to the 'BBB+' level.
- Prior to the coronavirus outbreak in North America about 25% of the utilities had a negative outlook or ratings that were on CreditWatch with negative implications.
- Additionally, many utilities with a stable outlook have minimal financial cushion at the current rating level.
- We expect COVID-19 will weaken the industry's 2020 funds from operations (FFO) to debt by about 100 basis points.

S&P Global Ratings acknowledges a high degree of uncertainty about the rate of spread and peak of the coronavirus outbreak. Some government authorities estimate the pandemic will peak about midyear, and we are using this assumption in assessing the economic and credit implications. We believe the measures adopted to contain COVID-19 have pushed the global economy into recession (see our macroeconomic and credit updates here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

S&P Global Ratings is revising downward its assessment of the North America utility industry to negative from stable. The North America utility industry consists of about 250 water, gas, and electric utilities. While we expect the sector to remain an investment-grade industry, we nevertheless project a modest weakening of credit quality within the industry. Credit quality had been gradually weakening prior to the COVID-19 outbreak with about 25% of companies on negative outlook or with ratings on CreditWatch with negative implications. We view COVID-19 as a source of incremental pressure and expect that the recession will lead to an increasing number of downgrades and negative outlooks. Currently, the median rating within the industry is 'A-' and over the next 12 months, we expect that the industry median could move to 'BBB+'.

Credit Quality Was Weakening Even Before COVID-19

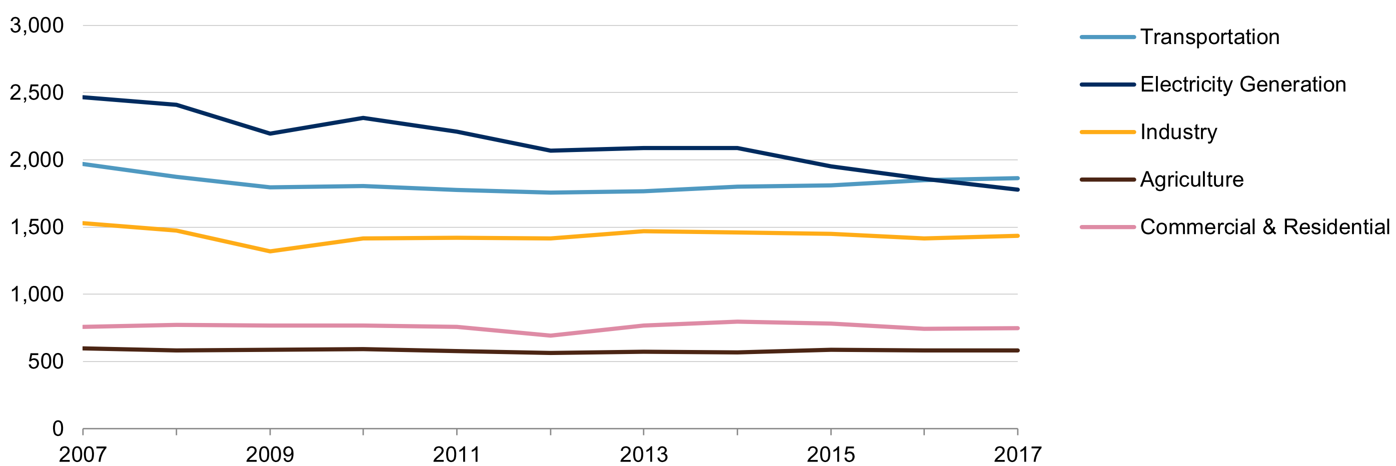
The North America regulated utility industry's credit quality was already weakening prior to COVID-19. This reflected companies' more consistent ability to manage credit measures closer to the downgrade threshold, leaving very minimal financial cushion at the current rating level. We generally view the industry's cash flows as more predictable and steady than most other corporate industries. Even so, unless a management team can proactively implement corrective actions, a utility with minimal financial cushion at the current rating coupled with an unexpected material event, typically results in a negative outlook or a downgrade.

The industry has faced many unexpected events and credit obstacles over the past two years. Some of these include safety (NiSource Inc.), wildfires (PG&E Corp., Edison International, and Sempra Energy), large capital projects (Southern Co., SCANA Corp., Eversource Energy, Duke Energy Corp., and Dominion Energy Inc.), utility acquisition (Fortis Inc., Emera Inc., ENMAX Corp., and NextEra Energy Inc.), and nonutility acquisitions (DTE Energy Co.). Each of these instances have either significantly reduced the prior cushion at the current rating level, triggered negative outlooks, or downgrades.

Also pressuring the industry's credit quality is the critical focus on environmental, social, and governance (ESG) factors. Over the past decade, the industry has done an outstanding job to significantly reduce its greenhouse gas emissions and reduce its reliance on coal-fired generation.

Chart 1

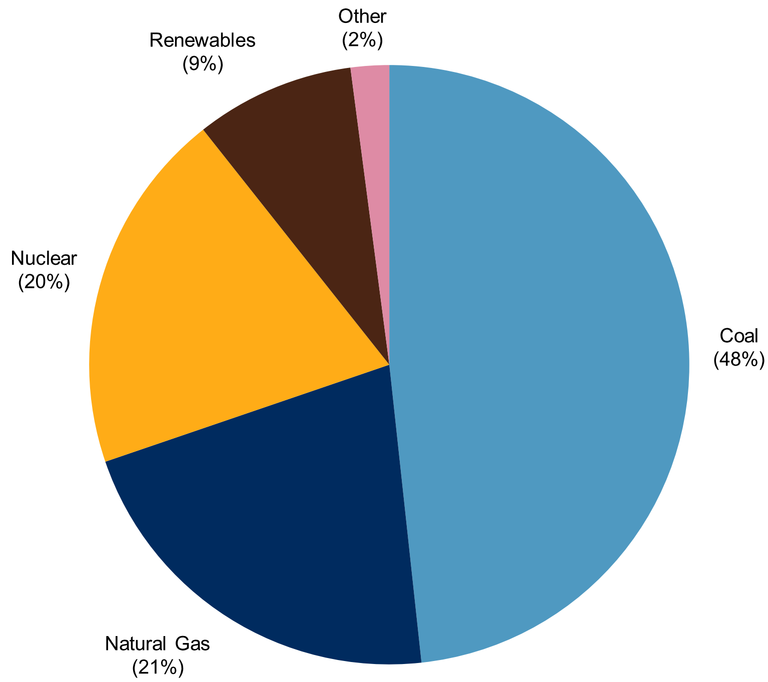
Total U.S. Greenhouse Gas Emissions By Economic Sector From 2007-2017
Million metric tons of CO2 equivalents



Source: U.S. Energy Information Administration.

Chart 2

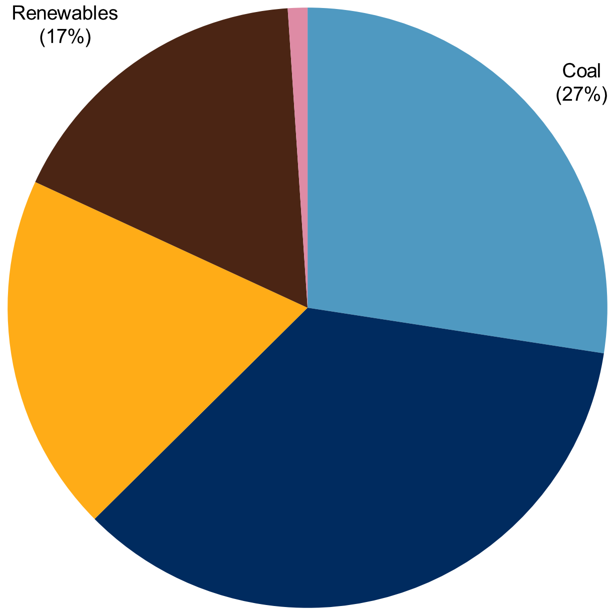
U.S. 2008 Generation Mix



Source: U.S. Energy Information Administration.

Chart 3

U.S. 2018 Generation Mix



Source: U.S. Energy Information Administration.

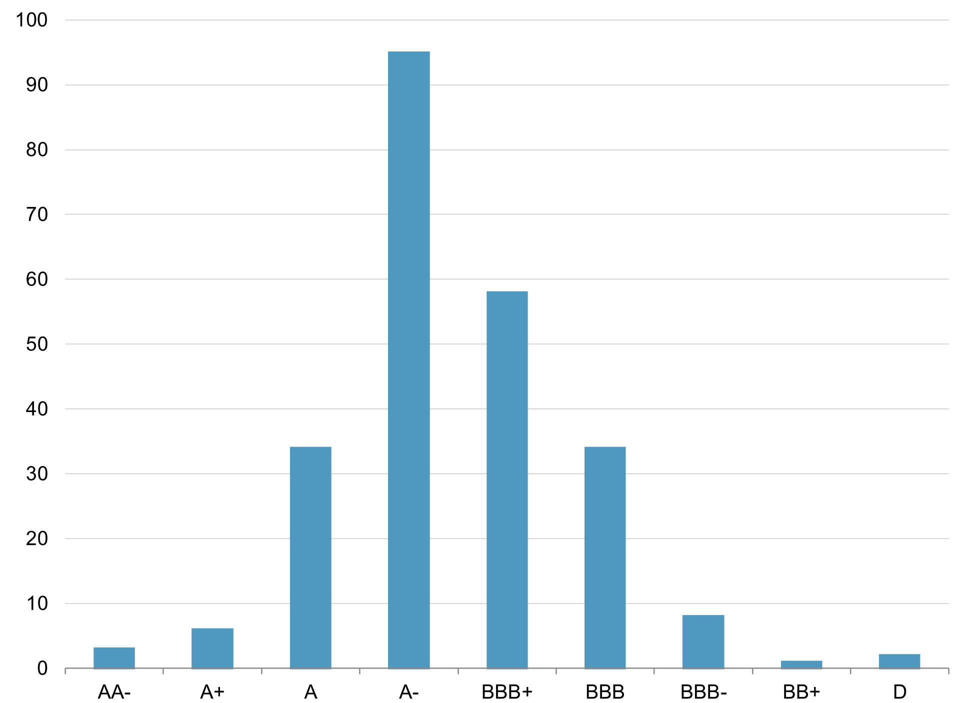
However, there are individual companies such as American Electric Power Co. Inc., Ameren Corp., and Evergy Inc. that despite having long-term plans to reduce their reliance on coal-fired generation, will continue to rely heavily on that fuel source for the next decade, possibly pressuring credit quality.

Rating Upgrades And Downgrades

Over the past decade, there have been generally more upgrades than downgrades in the sector. This has strengthened the utilities' credit quality since the financial recession and currently, the median rating within the industry is 'A-'.

Chart 4

North American Regulated Utilities Ratings Distribution 2019

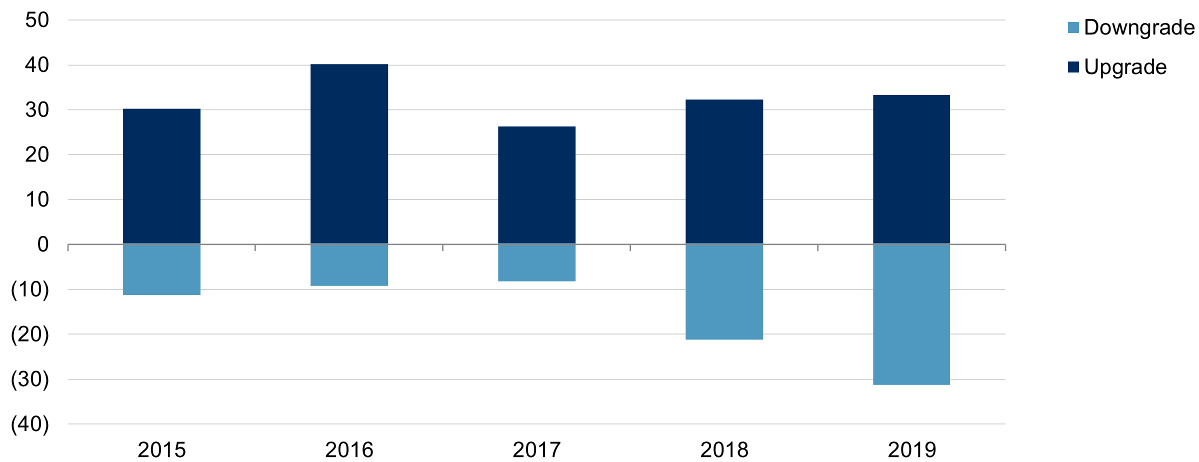


Source: S&P Global Ratings.

When analyzing our rating upgrades and downgrades in the sector for 2019, even prior to COVID-19, we note a weakening of credit quality.

Chart 5

North American Regulated Utilities Upgrades And Downgrades



Source: S&P Global Ratings.

While 2019 may initially appear to be similar to prior years with upgrades outpacing downgrades at 33 to 31, the underlying analysis tells a different story. In 2019, about 60% of the upgrades were attributed to S&P Global Ratings' revised group rating methodology criteria. Under the revised criteria, we placed more emphasis on the regulation of a utility allowing for a subsidiary with effective regulation and with a stand-alone credit profile that is higher than its group to potentially be rated higher. Absent the revised criteria, downgrades would have outpaced upgrades by 30 to 13 in 2019. This is a clear indication that even before COVID-19, the credit quality of the North America regulated utility sector had weakened.

Operating With Minimal Financial Cushion

While many companies with a negative outlook such as Puget Energy Inc. have minimal financial cushion at their current rating level, many others with a stable outlook also have minimal financial cushion at their current rating level. Companies with a stable outlook and minimal financial cushion include Exelon Corp., ALLETE Inc., American Water Works Co. Inc., Edison International, AVANGRID Inc., DPL Inc., CenterPoint Energy Inc., and Madison Gas & Electric Co. As the financial effects of COVID-19 continue to take hold, we expect that even companies with stable outlooks may experience ratings downward pressure. This is another reason that underscores our assessment that the industry outlook has turned negative.

How COVID-19 May Affect The Sector

In general, we assume that the U.S. will experience more than a 12% contraction in GDP during the second quarter and estimate the pandemic will peak between June and August (Global Macroeconomic Update, March 24: A Massive Hit To World Economic Growth, March 24, 2020).

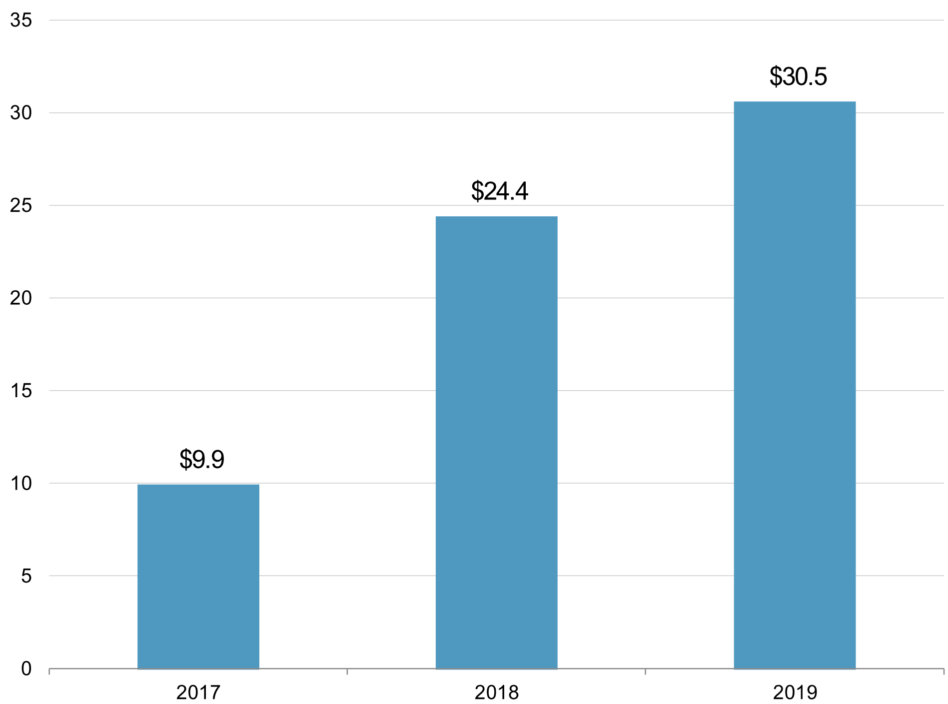
For the North America utility industry, we expect that COVID-19 will reduce the commercial and industrial (C&I) usage (North American Regulated Utilities Face Additional Risks Amid Coronavirus Outbreak, March 19, 2020). While some utilities will be able to offset some of the lower C&I usage through various regulatory mechanisms that include decoupling of revenues mechanisms and formula rates, many others will see a weakening of sales. Furthermore, as the recession continues to take hold, we expect bad debt expense will increase as it becomes increasingly more difficult for customers to pay their bills. While many utilities can defer these costs for future recovery, as these balances grow, historically we have seen incidents where utilities negotiate with their commission's to write off some of these costs as part of a larger agreement. Overall, we expect that these effects will result in a weakening of credit measures.

On a positive note, the industry continues to exhibit adequate liquidity and access to the debt markets, despite uneven performance of the commercial paper market for tier 2 issuers. The industry is benefiting from proactive risk management of establishing large credit facilities, having good access to additional liquidity through new term loans from banks, and public issuance of utility debt. These positive developments contrast to the last financial recession, when many utilities fully drew on their available credit lines and access to the banks or to the public debt market was effectively shut for many weeks.

Yet availability to the equity markets remains extraordinarily challenging. In 2019, the industry issued more than $30 billion in equity to preserve credit quality and heading into 2020 many companies within the industry assumed equity issuances as part of their financing plans. Given the industry's negative discretionary cash flow because of its high capital spending and lack of access to the equity markets, we expect that this will also lead to a weakening of credit measures.

Chart 6

North American Regulated Utilities Equity Issuance In Billions



Source: S&P Global Ratings.

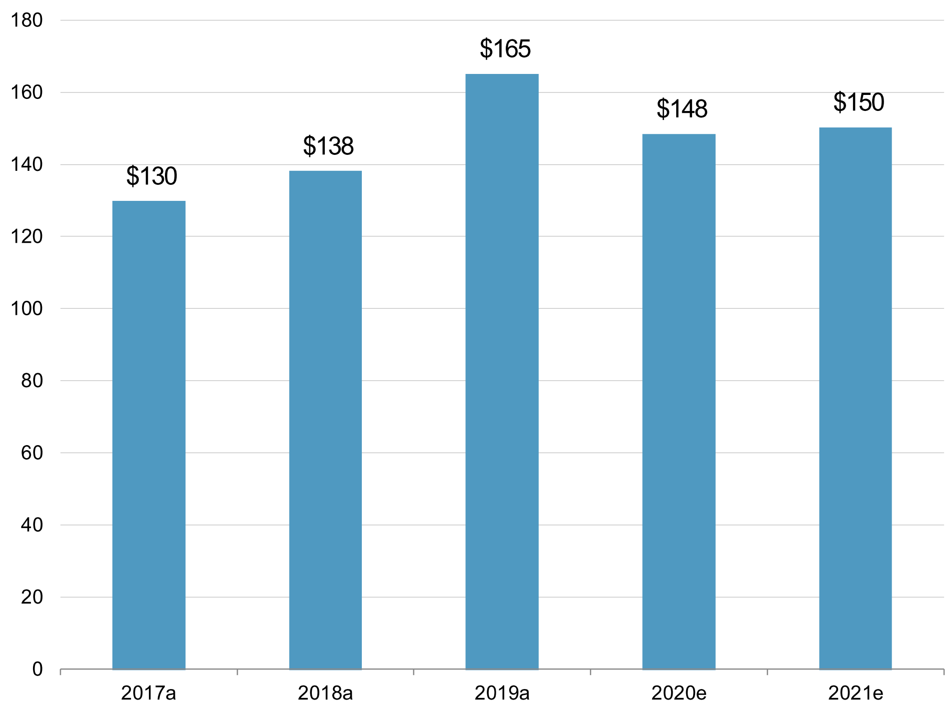
Another area of concern are utilities that rely to various degrees on nonutility businesses that have commodity exposure (S&P Global Ratings Cuts WTI And Brent Crude Oil Price Assumptions Amid Continued Near-Term Pressure, March 19, 2020). These include OGE Energy Corp., CenterPoint Energy Inc., DTE Energy Co., Dominion Energy Inc., Public Service Enterprise Group Inc., NextEra Energy Inc., and Exelon Corp. While many of them are well hedged in the near term, volumetric risk and a longer-term weakening of commodity prices could have a material effect on their credit measures. Overall, assuming that the effects of COVID-19 is only temporary, we would expect that the industry's 2020 FFO to debt will weaken by about 100 basis points, consistent with our revised negative outlook for the industry.

The Industry Has Levers

Depending on the severity of the recession, the industry has important levers that could mitigate some of the risks. This includes reducing capital spending and dividends. Currently, we estimate that 2020 capital spending will approximate $150 billion.

Chart 7

North American Regulated Utilities Capital Expenditures In Billions



a--actual. e--estimate. Source: S&P Global Ratings.

Based on our conversations with the companies within the industry there is a wide range as to how deeply a utility can reduce its capital spending and still maintain safe and reliable services. Some utilities can only reduce capital spending by as little as 15%, others by as much as 60%. Our analysis indicates that the majority of utilities could reduce their capital spending on a temporary basis by about 40% and maintain safe operations. Should the recession prolong, we would expect that the industry would generally first reduce capital spending and only afterward cut dividends. There is precedent that during times of high financial stress, utilities have reduced their dividends and we would expect that the industry, if necessary, would use this lever, acting prudently to preserve credit quality.

Credit quality of the North America regulated utility industry was already weakening prior to COVID-19. We believe that incremental challenges that the industry will face from this recession exacerbates financial pressure and underpins our revised negative outlook for the industry. However, we also expect that this industry's credit quality will continue to outperform most other corporate industries despite these challenges. Furthermore, we expect that the utilities will use the levers available to them to reduce credit risks and limit the financial impact from COVID-19. Overall, while we expect a weakening to the industry's credit quality, we continue to firmly believe that this industry will remain a high-quality, investment-grade industry.

This report does not constitute a rating action.