HIGHLIGHTS

- The industry’s average credit rating improved to BBB+ during 2014’s first half after holding steady at BBB for more than ten years.
- Ratings activity over the first six months of the year totaled 95 changes, well above last year’s pace, reflecting Moody’s decision in late January to upgrade most regulated utilities by one notch.
- During 2014’s first half, parent-level ratings were impacted by three upgrades and no downgrades.
- Earlier this year, S&P and Moody’s published utility industry credit outlooks that foresaw stable credit profiles due to a continued focus on regulated operations and improving state regulatory environments. Neither agency raised major concerns about risks to the industry’s credit strength in the near to medium terms.

COMMENTARY

The industry’s average credit rating improved to BBB+ by mid-year 2014 after holding steady at BBB for more than ten years. Total ratings activity, at 95 changes through June 30, was much higher than in the first half of 2013, reflecting Moody’s decision in late January to upgrade most regulated utilities by one notch. As a result, the year’s actions so far have been largely positive, with 92 upgrades outnumbering three downgrades. EEI records upgrades and downgrades at the subsidiary level, therefore multiple actions within a single parent holding company are included in upgrade/downgrade totals.

During 2014’s first half, parent-level ratings were impacted by three upgrades and no downgrades. The upgrades centered on companies’ continued focus on regulated operations and effective management of regulatory risk as well as
II. Credit Rating Agency Upgrades and Downgrades

U.S. Shareholder-Owned Electric Utilities

Note: Data presents the number of occurrences and includes each event, even if multiple actions occurred for a single company.

Source: Fitch Ratings, Moody’s, Standard & Poor’s

III. Total Ratings Actions

U.S. Shareholder-Owned Electric Utilities

2008 2009 2010 2011 2012 2013 2014*
Fitch 17 14 24 16 23 26 23 10
Moody’s 6 23 20 7 11 20 17 80
Standard & Poor’s 27 20 36 15 23 30 40 5
Total 50 57 80 38 57 76 80 95

Note: Full year, except where noted. / * Through June 30

Source: Fitch Ratings, Moody’s, Standard & Poor’s

IV. Direction of Ratings Actions

U.S. Shareholder-Owned Electric Utilities

Upgrade % Total Actions

Note: Full year, except where noted.

Source: Fitch Ratings, Moody’s, Standard & Poor’s
company-specific factors. As of July 1, 2014, approximately 82% of companies’ ratings outlooks were Stable, 11% were Positive or Watch-Positive and 7% were Negative or Watch-Negative.

The industry’s revised rating of BBB+ reflects a rounding-up of EEI’s calculated average (for details, please see the Excel data file that accompanies this report on EEI’s website). Following is a summary of 2014’s parent-level ratings actions through June 30, all of which occurred in the second quarter.

**Q2 Upgrades Reflect Ongoing Regulated Focus**

Ratings changes in the second quarter included three parent company-level upgrades.

**Edison International**

On April 8, S&P raised its corporate credit rating on Edison International (EIX) by two notches, to BBB+ from BBB-, on the emergence from bankruptcy of the company’s former unregulated subsidiary, Edison Mission Energy. At the same time, S&P affirmed its rating on EIX’s primary subsidiary, regulated utility Southern California Edison (SCE), at BBB+. S&P observed that SCE “represents virtually all” of EIX’s credit profile and has business fundamentals that are “slightly better” than most of its integrated electric utility peers. S&P noted that SCE’s service territory is “improving but still struggling,” its financial health is protected by “strict and restrictive” oversight by the California Public Utilities Commission, the company’s earned returns are “normally
healthy” and cash flow is supported by various rate mechanisms. S&P also commented that SCE’s operating risk is worse than average, as was highlighted by the problems it faced at the San Onofre nuclear plant.

Regarding EIX’s financial metrics, S&P commented that it expects the utility’s leverage to modestly increase with rising capital spending. The agency forecasts funds from operations (FFO) to debt of about 21% to 23% in the near term and debt to EBITDA of more than three times over the next several years.

While S&P’s upgrade of EIX was driven largely by the successful resolution of EME’s bankruptcy, the agency also noted that management’s “stated plans to focus mainly on regulated activities” as well as its commitment to maintaining a stable financial profile were important considerations.

**Westar**
On April 29, S&P raised its corporate ratings on Westar Energy and utility subsidiary Kansas Gas & Electric to BBB+ from BBB. The upgrade reflected S&P’s assessment of the parent company’s improved business risk profile as a result of management’s continuing focus on regulated operations, effective management of regulatory risk and “strengthening cost recovery through the regulatory process”.

S&P stated that Westar’s reduced business risk had led to stable profits and stronger financial metrics. The agency commented that the company’s ongoing capital spending would require timely recovery through “various rate mechanisms including base rates and rate surcharges” that were likely to improve cash flow. Furthermore, S&P noted that Westar’s investment in emissions control equipment at the La Cygne coal plant, which it jointly owns with Great Plains Energy’s Kansas City Power & Light, does not benefit from rider recovery, meaning that Westar would need to seek base rate changes to recover its costs.

S&P forecast Westar’s FFO to debt at 18% to 20% over the next three years and cash flow from operations (CFO) to debt at 17.5%. The agency noted it expects capital expenditures to decline following completion of the La Cygne plant’s emissions controls, and discretionary cash flow therefore to be “much less negative”, reducing the need for new debt and equity capital.

**Great Plains Energy**
On May 1, S&P raised its corporate ratings on Great Plains Energy (GPE) and subsidiary Kansas City Power & Light to BBB+ from BBB. The agency’s rationale was largely the same as for Westar and Kansas Gas & Electric: management’s continuing focus on regulated operations, effective management of regulatory risk and improving cost recovery within the regulatory process. Each of these developments served to improve the companies’ business risk profiles. As with Westar, S&P stated that Great Plains Energy’s capital spending program will likely benefit from timely recovery through base rates and rate surcharges, thereby strengthening cash flow.

S&P forecast GPE’s FFO to total debt at 18% over the next three years and CFO to debt at 16%. Similar to the case with Westar, as capital spending declines following completion of the La Cygne plant’s emissions controls, S&P expects GPE’s discretionary cash flow to strengthen.
Looking Ahead: A More-Regulated Business

While 2013 marked the tenth consecutive year of a BBB rating for the industry (based on EEI’s unweighted average of S&P ratings at the parent company level), it also saw the highest percentage of positive ratings actions in at least as many years. That trend persisted during first half of 2014, moving the industry’s average rating to BBB+ by mid year.

Early in 2014, both S&P and Moody’s published industry-level outlooks describing why they expect U.S. regulated utilities to maintain stable credit profiles over the remainder of the year. And while both agencies described positive factors that included the de-risking of utility business models through continued focus on regulated activities, Moody’s emphasized that improving industry regulation was the “most important” driver of its outlook.

Moody’s detailed its view of an improving regulatory environment more fully in a report dated February 3, 2014 (“U.S. Utility Sector Upgrades Driven by Stable and Transparent Regulatory Frameworks”). The report discussed reasons behind the agency’s November 2013 move to place most regulated utilities on review for upgrade and its January 2014 upgrade of most companies by one notch. Moody’s described how state-level regulation has evolved over the past several years for the better, including implementation of a “suite of transparent and timely cost and investment recovery mechanisms.” Moody’s said it expects the overall regulatory environment will remain “supportive and constructive” for at least the next three to five years.

In February 19 report (“Regulation Will Keep Cash Flow Stable as Major Tax Break Ends”), Moody’s said the end of bonus depreciation in 2013 would cause many utilities’ financial metrics to weaken but the improved regulatory framework — featuring both cost-recovery mechanisms and annual base-rate increases — would play a significant offsetting role. Moody’s offered several examples of positive rate case outcomes that are driving its industry outlook, such as Puget Sound Energy’s case in Washington and Westar Energy’s in Kansas (see above and EEI’s Rate Case Summary publication). Moody’s also said improved regulation is helping utilities manage the effects of sluggish customer demand. Moody’s commented that “a more contentious regulatory environment” or a “widespread adoption” of more-aggressive financial strategies could lead to a negative outlook while a “marked increase” in allowed ROEs or steps to scale back dividends and stock repurchases might lead to a positive outlook.

In a January 22 report, S&P discussed various factors behind its assessment of the industry’s stability, such as improving economic conditions, sustained demand for a “very critical” commodity, the “generally supportive” posture of regulators toward cost recovery for capital expenditures, and continued demand by investors for utility equity and debt securities. S&P stated that “we see little alteration in the sector’s business and financial risk profiles during periods of economic change” because of the essential nature of electricity, the regulated character of the business and the constructive regulatory environment. The agency also suggested that if the economy grows faster than it is expecting there could be “some modest improvement” in the industry’s credit profile.

Throughout these reports, neither S&P nor Moody’s raised major concerns about risks to the sector’s credit profile in the near to medium term.

Ratings by Company Category

The table S&P Utility Credit Rating Distribution by Company Category presents the distribution of credit ratings over time for the shareholder-owned electric utilities organized into Regulated, Mostly Regulated and Diversified categories. Ratings are based on S&P long-term issuer ratings at the holding company level, with only one rating assigned per company. At June 30, 2014, the categories had the following average ratings: Regulated = BBB+, Mostly Regulated = BBB+, and Diversified = BBB. ■