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Research:

Regulated Operations Back in Fashion for U.S. Electric Utilities

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Standard & Poor's Ratings Services expects that state regulatory commissions will be asserting themselves more vigorously regarding the operations and finances of U.S. electric utilities in the years to come. Despite the highly visible and highly damaging actions, or inaction, in Nevada and California, respectively, between 2000 and 2002, Standard & Poor's believes that fixed-income investors should consider the posture of other jurisdictions as more indicative of regulatory attitudes toward credit quality.

Standard & Poor's does not believe that these will be typical of regulatory behavior. A theme that has been resonating increasingly throughout the power industry in the past year is a "back-to-basics" strategy, which means reinstalling the regulated operation as the central focus of the larger diversified corporation. For years now, many players have de-emphasized this business as a burden on the financial juggernaut that unregulated generation and energy trading would create. But it has become manifestly clear, once again, that utility holding companies that stray very far from their traditional core business cannot, on any sustained basis, satisfy their own loftier earnings ambitions, nor those of the financial community that had pushed the industry for better performance during the heyday of the raging bull market.

Repair Job

"Back to basics" is how the industry is responding to the balance-sheet damage and cash flow drainage that so many experienced as the result of the ambitious endeavors, and to the subsequent heavy blow to investor confidence that had long been a cornerstone of the power industry. The repair work is substantial and, in fact, a few may have moved too late, with bankruptcy of the consolidated entity now a real possibility. The refocused business strategy entails disposing of nonperforming or habitually underperforming degraded assets, seriously deleveraging and eliminating speculative trading positions. These are all daunting tasks, to which such companies as Aquila Inc, TECO Energy Inc., and Allegheny Energy Inc. can attest. Execution risk is considerable.

On the surface, a back-to-basics strategy, i.e., the return to the relative security of a regulatory paradigm that most industry participants can manage, should be positive for credit quality. On the other hand, regulatory uncertainty inevitably rears its ugly head. One obvious danger, ironically, is a very low interest-rate environment that may drive authorized ROEs down. More justification on limiting ROEs will come from eliminating double taxation on dividends. A recent example of this downward pressure is the pending settlement of Public Service Electric & Gas Co.'s distribution rates and recovery of deferred restructuring costs, in which a 9.75% ROE has been agreed to. We can expect regulators to be very concerned with granting significant rate hikes, although cost pressures on many utilities could be significant as they struggle with the attrition caused by years without a rate filing following restructuring legislation and regulatory rule-making. Rising pension obligations and health-care costs will only add to the headaches that commissions will have due to these upward rate pressures. A jaded rate-paying public and their advocates who are less than enamored of utility holding companies' behavior and performance will surely make their case for nixing rate increases.

When Regulated Operations Cause Downgrades

At the same time, it is useful to look back about 18 months to consider the extent to which Standard & Poor's has downgraded utilities as a result purely of the performance of the regulated operations rather than because of the utilities' affiliation with merchant generation developers and energy traders. In 2002, of the 182 downgrades in the power industry, only 11, or 6%, reflected the weakening of the regulated businesses, and so far in 2003, it is also about 11, versus the 81 total downgrades. The most commonly noted reason for the downgrades was deteriorating financial measures frequently due to managements' decisions to weaken the capital structure and prime the ROE pump. In two cases, holding companies leveraged up to complete a merger (Ameren Corp. and SCANA Corp.). In one action, Standard & Poor's concluded that the insulation that we had formerly accorded Arizona Public Service Co. to raise its rating above the consolidated corporate credit rating of parent Pinnacle West Capital Corp. was no longer sufficient, especially when compared with the greater insulation mechanisms or regulatory rule-making that existed in other jurisdictions. Of course, the prominent example of the Nevada commission's decision in 2002 to disallow $437 million of cost deferrals remains firmly entrenched in the collective memory of fixed-income investors as to just how far regulatory relations can deteriorate.

That so few downgrades occurred because of weakened credit profiles of utilities themselves is attributable in no small measure to the support provided by state commissions in recent years. We should look at the record that a few states have left to perhaps gain some insight into what to expect on the regulatory front. Iowa and New Mexico have established frameworks that provide utilities advance assurance of recovery of capital expenditures related to new generating assets. In Iowa, pre-approval for rate-making treatment and a prohibition on after-the-fact prudence hearings became law. In New Mexico, a global settlement with Public Service Co. of New Mexico requires, among other things, that any debt-financed, wholesale-related generation must have no more than 50% debt in its capital structure, and the company's entire wholesale fleet must have 75% of its capacity committed to at least five-year contracts. In Idaho, the state commission authorized Idaho Power Co to recover the costs that the utility incurs in hedging its large variable hydroelectric exposure. In Indiana, the Utilities Regulatory Commission is giving utilities incentives to avoid the spot market and to buy power in advance. A purchased-power tracker for PSI Energy Inc., for instance, allows the utility to recover 90% of its forward power costs, with the remaining 10% subject to future prudency consideration in a full rate case.

These actions are typical of supportive behavior exhibited in other states. Furthermore, it is interesting to note that most states have maintained, and a few more have implemented, power cost recovery mechanisms.

Some Questions

Finally, should we discount the idea that some companies will yet again succumb to the temptation to develop noncompetency-based businesses to stoke returns, and relegate the regulated business to the backburner? Will the power industry, and the equity community that has had such a pronounced influence on it, again develop a disdain for 1% to 2% average annual growth, especially if a bull market ever returns? It is not beyond the pale that managements will have anaesthetized themselves against the memory of their current pain. If diversification strategies reappear, expect Standard & Poor's to take rapid action on ratings and outlooks. Even where a commission's initial stance was unfavorable to credit quality, such as in Washington State where there were significant doubts about the ability of Avista Corp. and Puget Sound Energy Inc. to recover deferred power costs incurred during the western U.S. power crisis, the commission eventually allowed the utilities to recover their costs and implemented a deferred cost-recovery mechanism for the future.