Industry Top Trends 2020
North America Regulated Utilities
A stable industry with a rising percentage of negative outlooks

What’s changed?

**Negative credit bias.** About 25% of all North America utilities either have a negative outlook or are on CreditWatch with negative implications.

**California’s Investor Owned Electric Utilities.** While wildfires remain operationally challenging for California’s utilities, we expect that the passage of SB 1054 into law adds sufficient financial credit enhancements to protect the utility’s credit quality over the next several years, absent near-term catastrophic wildfires.

**Weak financial measures.** These have weakened over the past three years and funds from operation (FFO) to debt has on average decreased by about 300 basis points (bps), in part due to tax reform, elevated capex, and leveraged acquisitions.

What to look for in the sector in 2020?

**Large capital projects.** Companies actively building new nuclear generation, liquefied natural gas projects, and interstate pipelines have all recently faced project delays and higher costs that could affect credit quality.

**Environmental risks.** Utilities with significant coal generation face higher regulatory scrutiny and environmental risks. Recent uncertainties regarding coal ash recoveries continues to highlight regulatory risks for coal generation.

**Mergers and acquisitions (M&A).** We expect that the pace of M&A activity may increase as companies search for growth. Furthermore, an increasing number of states passing Fair Market Value legislation may increase the acquisition of water municipalities.

What are the key medium-term credit drivers?

**Minimal financial cushion.** Most large and medium sized companies are managing cash flow measures at the rating downgrade threshold. This reduces the financial cushion they have to protect current credit ratings should unexpected events occur.

**Regulatory and political risks.** If the economy turns down, raising customers’ bills may become challenging. Political pressure to expedite carbon emission reductions and increase renewable investments could have repercussions for the customer bill. These pressures could increase the difficulties of managing regulatory risk.
Ratings trends and outlook

North America Regulated Utilities

Chart 1
Ratings distribution

Chart 2
Ratings outlooks

Chart 3
Ratings outlook net bias

Industry Top Trends 2020: North America Regulated Utilities

Industry credit metrics

North America Regulated Utilities

Chart 4
Debt / EBITDA (median, adjusted)

Chart 5
FFO / Debt (median, adjusted)

Chart 6
Cash flow and primary uses

Chart 7
Return on capital employed

Source: S&P Global Ratings, S&P Global Market Intelligence. All figures are converted into U.S. Dollars using historic exchange rates. Forecasts are converted at the last financial year-end spot rate. FFO—Funds from operations.
Industry outlook

Key assumptions

1. Growth is challenging
Due to conservation and efficiency, the electricity industry can no longer rely on traditional sales growth. While few utilities continue to benefit from strong new customer growth, most utilities are facing flat to declining sales growth. To achieve growth, many in the industry are turning to M&A, contracted assets, and other non-utility businesses.

2. Managing the customer's bill
The utility industry has effectively managed rises in the customer bill over the past decade, benefiting from lower cost shale gas and historically low interest rates. However, capital spending remains robust and the industry must find savings from technology and process improvements to offset these higher costs.

3. Carbon Risks
Over the past decade the utility industry has taken significant steps to proactively reduce its reliance on coal fired generation and its associated level of carbon emissions. The industry is no longer the number one North America emitter of carbon and has reduced its coal fired generation by about 50%. Still, about 30% of utilities that generate electricity rely on coal fired generation, producing at least 50% of their electricity from coal. Additionally, about two-thirds of those utilities rely on coal fired generation for more than 70% of their total generation. Investors are increasingly focused on environmental issues and we expect the industry will continue to decrease carbon exposure by increasing its reliance on renewables, batteries, and natural gas.

Volume growth for many utilities has stagnated over the past decade, encouraging many companies to invest in higher risk large regulated capital projects, M&A opportunities, contracted assets, and other non-utility businesses to demonstrate growth. Each of these strategies has introduced various risks including rising leverage, higher business risk, project delays, and higher costs. We expect this trend to continue as long as electricity sales growth remains stagnant.

While conservation has flattened electric utility volumetric sales over the past decade, one area of potential growth is electric vehicles, which could increase utility infrastructure investments and higher volumetric sales growth. Some state utility commissions are allowing utilities to invest in charging stations while others have approved pilot programs to increase utility rate base investments. Charging an electric vehicle uses about the same electricity as running a typical central air conditioner for six hours, potentially growing a utility's electricity volumes. Additionally, if the charging of electric vehicles is mostly done during off peak hours, minimal incremental infrastructure investments would be required to meet the additional load, providing a net benefit for the industry.

To shield the customer bill from the effects of rising capital spending, we expect utilities will continue to pursue technology to reduce costs. For example, many utilities have implemented automatic meter readers and are in the early stages of implementing drone technology. Furthermore, as battery technology improves and the cost of renewable electricity decreases, we expect the industry will further invest in electricity production from these carbon free technologies.
Higher coal ash costs may be a rising risk for a few electric utilities. Coal ash is a byproduct of burning coal. While the industry, in general, has effectively managed this risk, we are now seeing some cases of this risk escalating. Recently, the North Carolina Department of Environmental Quality ordered Duke Energy Corp. to fully excavate its remaining coal ash basins in the state. Duke estimates that the cost to comply could be as high as $5 billion over the next several years. It is conceivable that other utilities with significant coal ash exposure could face similar risks.

We believe utility investments in U.S. offshore wind will significantly grow over the next seven years and may lead to the installation of as much as 14 gigawatts of offshore wind capacity. If this capacity is installed it would equate to more than three-quarters of all the offshore capacity installed in Europe, which has been developing and installing offshore wind projects for the past three-decades. The potential growth is primarily driven by East Coast states looking to meet renewable and clean energy targets. Currently in the U.S. there is only one offshore windfarm online (Block Island Wind), but companies such as Avangrid, Eversource, Public Service Enterprise Group, and Dominion Energy could all have projects online by 2023. In general, we view offshore wind as having higher risk than traditional onshore wind projects due to its generally higher costs, complexity to build that can lead to cost overruns, possible siting and permit delays, and higher operational risks. However, the long-term contracted nature of these offshore wind projects with other utilities could mitigate some of the aforementioned risks.

The era of new North America nuclear power plant construction appears to be nearing its end. In 2017 SCANA Corp. abandoned its construction of two new nuclear units on increasing construction costs and further project delays. While Southern Co. is continuing with its nuclear construction projects, significant construction and execution risks exist and the company may face regulatory disallowances when they come online. Absent a new approach to nuclear technology, we do not expect another utility in North America to build a new nuclear generating facility.
Key risks and opportunities

1. Managing Regulatory Risks
Utilities have generally managed regulatory risk, consistent with an almost entirely investment-grade industry. Over the past decade, utilities have reduced their regulatory lag through the use of forward looking test years, formula rate plans, multi-year rate orders, increasing use of rider mechanisms, and decoupling.

2. When the Credit Cycle Turns
Our base-case outlook for credit quality reflects our view that most North American utilities would withstand a change to the credit cycle. However, in some cases, we expect that companies with minimal cushion at their current rating level could experience a downgrade. The ability to quickly pass cost increases to customers during a recession may increase the regulatory lag and weaken a utility’s financial measures, eroding the credit cushion for some utilities.

3. Capital Spending and Negative Discretionary Cash Flow
Annual capital spending for the industry remains robust at about $140 billion. The industry is primarily focused on smaller projects that enhance safety, reliability, productivity, and reduce carbon emissions. While spending at this level grows rate base and earnings, discretionary cash flow will remain negative. This requires the industry to maintain consistent access to the capital markets at competitive rates to fund the negative discretionary cash flow.

We expect that the generally stable North America utility industry will continue to have a relatively high percentage (15%-30%) of issuer credit ratings that either have a negative outlook or are on CreditWatch with negative implications. Companies are strategically managing their cash flow measures closer to the downgrade threshold with minimum cushion at the current rating level. An unexpected event such as a recession, wildfire, gas explosion, large project delay, or political interference, could all lead to a negative outlook or a downgrade.

For the industry to maintain its investment-grade credit quality, utilities must continue to manage regulatory risk and manage generally reduced authorized returns on equity (ROEs) and higher capital spending. Utilities have been able to improve their ability to consistently earn lower authorized ROEs by reducing regulatory lag through the use of forward looking test years, formula rates, multi-year rate orders, increasing use of rider mechanisms, and decoupling mechanisms. Another way some utilities have been able to increase their cash flow in lieu of lower authorized ROEs is by receiving a higher equity component within the regulated capital structure. These approaches highlight some of the tools that utilities have used to preserve credit quality despite the many challenges.

Although these tools work in many cases, their degree of credit supportiveness is often limited when a utility is facing operational risks, such as gas explosions or wildfires. In California, for example, customer fatigue from the constant de-energization (shutoff) of power lines is growing, which is increasing political pressure within the state. This may increase regulatory risk for some of the state’s utilities.

As part of the industry’s capital spending program, we expect it will continue to reduce its reliance on carbon-emitting fossil fuels. Over the past decade the utility industry has reduced its reliance on coal, but several individual utilities remain laggards. We expect utilities will continue to decrease their carbon emissions even if the utility operates in a state without renewable portfolio standards. Stakeholders are increasing their scrutiny...
of utilities with higher carbon emissions, possibly pressuring those utilities to expedite their decarbonization process.

While some utilities have increased their renewable portfolio to meet a state-specific standard, others have reduced their reliance on coal even while operating within a state without a renewable portfolio standard. Conversely, to contain rate increases some utilities without renewable portfolio standards are moving at a more measured pace to reduce their carbon emission. Some of these utilities operate in Alabama, Indiana, Kentucky, Mississippi, Montana, West Virginia, and Wyoming.

Related Research

- Credit FAQ: The Looming California Wildfire Season Prompts An Examination Of Investor-Owned Utilities’ Risks, June 7, 2019
- U.S. And Canadian Regulatory Jurisdiction Updates And Insights, May 14, 2019
- ESG Industry Report Card: Regulated Utilities Networks, May 13, 2019
- For Canadian Utilities, Credit Quality Will Depend On Executing Key Strategies, April 11, 2019
- Will California Still Have An Investment-Grade Investor-Owned Electric Utility? Feb. 19, 2019