

SECTOR IN-DEPTH

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US Regulated Electric and Gas Utilities

High Leverage at the Parent Often Hurts the Whole Family

US utilities use leverage at the holding-company level to invest in other businesses, make acquisitions and earn higher returns on equity. In some cases, an increase in leverage at the parent can hurt the credit profiles of its regulated subsidiaries.

- » **High leverage at the parent can have negative implications for the whole family.** The larger the parent's unregulated businesses are and the larger its holding-company debt is as a share of consolidated debt, the greater the likelihood that credit quality in the family will suffer. Increased leverage at the holding company often leads to a more than one-notch rating difference between the holding company and the operating company.
- » **When a parent exits a large unregulated business, holding-company debt sometimes remains.** There are instances, such as [CMS Energy Corp.](#) (CMS, Baa2 stable) and [TECO Energy Inc.](#) (TECO, Baa1 stable), in which holding company debt once used to finance unregulated businesses remains even after the parent has exited the business, placing additional stress on the credit profiles of regulated utilities within the family. The regulated utility finds itself not only responsible for servicing its own debt but also for supporting the parent's debt.
- » **"Double leverage" drives returns for some utilities but could pose risks down the road.** The use of double leverage, a long-standing practice whereby a holding company takes on debt and downstreams the proceeds to an operating subsidiary as equity, could pose risks down the road if regulators were to ascribe the debt at the parent level to the subsidiaries or adjust the authorized return on capital.
- » **Regulators could take steps to mitigate contagion risks within the family.** Ring-fencing techniques can go a long way toward insulating the regulated utility, as in the case of [Oncor Electric Delivery Company LLC](#) (Baa1 senior secured rating, positive). But complete protection from an insolvent parent is not guaranteed. Also, regulators could attempt to influence changes in the capital structure or could adjust a utility's allowed rate of return because of the parent's use of double leverage, although we have not seen this in practice.

All in the Family

Unlike most US corporates in unregulated industries, US regulated electric and gas utilities typically have substantial barriers to the free movement of cash among members of the corporate family, and they issue material debt at their operating companies and at the holding-company level. As a result, we generally observe a meaningful difference in the credit profiles of US utility operating companies and their holding companies, a view that is often reflected in a difference in their respective ratings of one or more notches.

The most pervasive driver has been structural subordination of debt at the holding company. The operating company services its debt with cash flow from its operations, whereas the holding company depends on dividends from subsidiaries to service its debt obligations, which can be less certain. For US utilities, the greatest drivers of rating differentials of more than one notch have been the degree of leverage at the parent and/or investments in unregulated businesses with higher operating risk.

In our analysis of US utilities, we have also found that leverage at the parent has often had negative implications for the parent itself (with greater implications when the percentage of consolidated debt at the holding company was higher), and that very high leverage at the parent has affected the credit quality of the whole family. While an increase in leverage at the holding company does not increase structural subordination per se, it can exacerbate the impact of any structural subordination that exists. For instance, approximately 3% of the consolidated debt of [Pinnacle West Capital Corp.](#) (Baa1 positive) is at the parent, and there is a one-notch difference between its issuer rating and the issuer rating of its primary subsidiary, [Arizona Public Service Company](#) (A3 positive). By contrast, there is a two-notch difference between the issuer ratings of [Duke Energy Corp.](#) (A3 stable) and its two largest utility subsidiaries, partly because debt at the parent is 30% of the consolidated total.

We have also observed that unregulated businesses have added volatility to the cash flows of US utility holding companies. We do not view all unregulated businesses equally, since some are riskier than others, but volatility has generally been proportionate to the size of those businesses and the market risk to which they are exposed. For instance, there is a three-notch difference between the senior unsecured rating of [Public Service Enterprise Group Inc.](#) ((P)Baa2 stable), which has essentially no debt at the parent level but obtains about 40% of its cash flows from its unregulated power subsidiary ([PSEG Power LLC](#) , Baa1 stable), and the issuer rating of its utility subsidiary, [Public Service Electric and Gas Company](#) (A2 stable).

Furthermore, in some cases, depending on the amount of holding-company debt or the riskiness and scope of the unregulated businesses, the rating of the regulated utility has been constrained. An example of this is [Dayton Power & Light Company](#) (DP&L, Baa3 stable), a regulated utility whose rating is currently constrained by its highly leveraged parent, [DPL Inc.](#) (Ba3 stable), and to a lesser extent, its unregulated retail energy marketing affiliate.

Exhibit 1

Examples of Holding Companies Whose Debt and Unregulated Businesses Drive Wider Notching Differences

Holding Company	Unsecured / Issuer Rating	Primary Utility Subsidiaries	Unsecured / Issuer Rating	Notching Difference in Ratings	HoldCo Debt (% of Consolidated Debt)	Unregulated Business (% of Consolidated Earnings/Cash Flow)
Dominion Resources Inc.	Baa2	Virginia Electric and Power Company / Dominion Gas Holdings, LLC	A2	3	47%	20%
NextEra Energy, Inc.	Baa1	Florida Power & Light Company	A1	3	40%	50%
Sempra Energy	Baa1	Southern California Gas Company / San Diego Electric & Gas Company	A1	3	37%	16%
Public Service Enterprise Group Incorporated	(P)Baa2	Public Service Electric and Gas Company	A2	3	0%	40%
Otter Tail Corp	Baa2	Otter Tail Power Company	A3	2	11%	24%
OGE Energy Corp.	A3	Oklahoma Gas & Electric Company	A1	2	7%	25%
Entergy Corporation	Baa3	Entergy Louisiana, LLC / Entergy Arkansas, Inc.	Baa1 / Baa2	1 / 2	20%	24%

Source: Moody's Investors Service

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Since DP&L is the main source of cash flow to service DPL's high level of debt, in our credit analysis we have considered this debt part of DP&L's capital structure from a debt-servicing standpoint.

For a discussion of our approach to ratings within a utility family, please see Appendix D of our [Regulated Electric and Gas Utility Methodology](#), published December 2013.

Industry Consolidation Is a Key Driver of Holding-Company Debt

One of the main reasons for significant holding-company debt is merger and acquisition activity. DPL Inc. is one example. Its ultimate parent, The [AES Corporation](#) (Ba3 stable) acquired the regulated utility, DP&L, and financed it largely by placing an additional \$1.25 billion of debt at DPL Inc.

A more recent example is [The Laclede Group](#)'s (Baa2 stable) 2014 acquisition of [Alabama Gas Corp.](#) (Alagasco, A2 stable). An increase in debt of \$625 million at the parent level to finance the acquisition of Alagasco led us to downgrade Laclede Group's senior unsecured rating to Baa2 from Baa1. Laclede Group's holding-company debt increased to approximately 37% of total consolidated debt from less than 3%. Not only did the increase in debt drive the rating change at Laclede Group, but the significant holding-company leverage currently constrains Alagasco's A2 senior unsecured rating. Otherwise, Alagasco's rating could be higher given the utility's strong financial metrics and low risk business model operating in a credit-supportive Alabama regulatory jurisdiction.

The Last Man Standing

When a parent exits an unregulated business, some of the debt associated with the business remains at the holding company and can hurt the credit profiles of the remaining regulated subsidiaries. Some utility holding companies have sizable amounts of debt originally used to finance unregulated businesses that the parent exited, adding stress to the regulated utility's credit profile.

In this case, the regulated utility ends up responsible not only for servicing its own debt but also for supporting the legacy debt at the parent. Depending on the amount of legacy holding-company debt that remains, the de-leveraging effort can be a multiyear endeavor and, in some cases, requires the parent to reduce its dividend to maintain financial flexibility across the company.

One example is CMS Energy Corp. (CMS, Baa2 stable), parent of [Consumers Energy Company](#) (Consumers, A1 senior secured rating, stable), a regulated electric and gas utility in Michigan. About \$3.4 billion, or 34%, of its consolidated debt is at the parent. Much of

Energy Future Holdings Corp.: Too Much Holding-Company Debt Gone Wrong

Amid Energy Future Holdings Corp.'s (EFH, not rated) downward spiral, which culminated in bankruptcy in April 2014, we downgraded the senior secured rating of its indirectly owned regulated electric transmission and distribution utility, Oncor Electric Delivery Company LLC, to Baa3 in February 2013. We downgraded Oncor to one notch above speculative grade for several reasons: the highly leveraged capital structure at Energy Future Intermediate Holding Company LLC (EFIH, not rated), Oncor's indirect parent; EFIH's high reliance on dividends from Oncor to support debt service; and EFH's high reliance on Oncor's upstream tax payments to support debt service, along with the interwoven cash-transfer relationship between EFH and EFIH.

At the same time, Oncor's senior secured rating did not fall below investment grade given the strong insulation from the existing ring-fence-type arrangements. Rather, Oncor's lower rating reflected EFIH's heavy and permanent reliance on Oncor. We did not expect the ring-fencing mechanisms to fail, and we expected that Oncor would not be materially affected by the contagion risk of a default and restructuring at its affiliates or parent holding companies. Oncor's rating also reflected its strong fundamentals, including the stability and predictability of its revenue and cash flow as well as the supportive regulatory environment in Texas.

Since EFH's bankruptcy filing, we have upgraded Oncor's senior secured rating to Baa1, which reflects both the stability and predictability of Oncor's low risk rate-regulated business and the credit protection provided by the uncontested ring-fencing provisions. We expect the oversight from the Public Utility Commission of Texas will continue to substantially shield Oncor from any uncertainties associated with its parent holding companies.

this debt was used to finance its previous unregulated businesses, most of which CMS exited several years ago. Today, only about 5% of CMS's cash flows come from its remaining unregulated businesses. Given that the remaining unregulated businesses contribute modestly to consolidated results, the onerous amount of parent debt falls on the shoulders of Consumers. As such, the holding-company debt has constrained the rating of Consumers, given CMS's lack of material cash-flow diversification. The dividend upstream from Consumers is essential to servicing its parent's debt, which, in turn, limits the utility's ability to respond to unforeseen events, a credit negative.

[Entergy Corporation](#) (Baa3 stable) is another example of a utility holding company whose credit profile is currently constrained by the substantial amount of debt at the parent. This debt is largely tied to Entergy Corp.'s highly volatile and shrinking unregulated nuclear business, Entergy Wholesale Commodities (EWC, not rated). EWC's aging, small and concentrated portfolio, which operates mostly in the Northeast, has inherently high operating costs, is exposed to event risk and faces persistent local opposition and increasing regulatory mandates. As such, EWC's volatile earnings and cash flow are driven by a market of low power prices and rising operating costs. A significant amount of debt is associated with EWC (about \$2.8 billion of the total \$14 billion in consolidated reported debt) and resides at the parent holding company. In a stand-alone credit assessment, we have assessed EWC as below investment grade, which weighs on Entergy Corp.'s Baa3 rating. However, Entergy Corp.'s financial metrics are strong for its rating category and are enhanced by diverse and stable cash flows from its multi-state regulated utilities.

Exhibit 2

Examples of Holding Companies Whose Debt Is the Main Driver of Notching Differentials

Holding Company	Unsecured / Issuer Rating	Primary Utility Subsidiaries	Unsecured / Issuer Rating	Notching Difference in Ratings	HoldCo Debt (% of Consolidated Debt)	Unregulated Business (% of Consolidated Earnings/Cash Flow)
DPL Inc. *	Ba3	Dayton Power & Light Company	Baa3	3	60%	<10%
Duquesne Light Holdings, Inc.	Baa3	Duquesne Light Company	A3	3	48%	<10%
The Laclede Group	Baa2	Alabama Gas Corporation / Laclede Gas Company	A2 / (P)A3	2 / 3	37%	5%
ITC Holdings Corp.	Baa2	All four transcos (e.g. ITC Midwest LLC)	A3	2	55%	0%
IPALCO Enterprises, Inc.	Baa3	Indianapolis Power & Light Company	Baa1	2	35%	0%
CMS Energy Corp	Baa2	Consumers Energy Company	A3**	2	34%	5%
Integrus Energy Group,, Inc.	A3	Wisconsin Public Service Corporation	A1	2	31%	<5%
Puget Energy Inc.	Baa3	Puget Sound Energy, Inc.	Baa1	2	31%	0%
Duke Energy Corporation	A3	Duke Energy Carolinas, LLC / Duke Energy Progress, Inc.	A1	2	30%	15%
TECO Energy Inc.	Baa1	Tampa Electric Power Company	A2	2	29%	<5%

* The ultimate parent of DPL Inc. and Dayton Power & Light Company is The AES Corp. (Ba3 stable). ** Consumers Energy Company does not have a senior unsecured rating but a first-mortgage bond senior secured rating of A1. Therefore, its implied senior unsecured rating is A3.

Source: Moody's Investors Service

Double Leverage Helps Drive Returns for Some Utilities but Adds Stress on the Family's Credit Profile

Double leverage, whereby the holding company takes on debt and downstreams the proceeds to its operating subsidiary, is a long-standing practice in the industry. If down the road regulators decide to revisit this corporate financial strategy by imputing holding-company debt to subsidiaries, it could hurt credit quality across an issuer's family. The principal reason is that US regulators generally set rates based on an actual capital structure at the utility and provide a higher return to the equity capital component.

Many of the utility holding companies we rate use double leverage in one form or another. [ITC Holdings Corp.](#) (ITC, Baa2 stable) is a holding company of electric transmission regulated operating subsidiaries: [International Transmission Company](#), [Michigan Electric](#)

[Transmission Company LLC](#) , [ITC Midwest LLC](#) and [ITC Great Plains LLC](#) . Each subsidiary has a senior unsecured rating of A3, two notches higher than ITC's rating. ITC has historically issued debt at the parent level to finance acquisitions and equity infusions for its transmission subsidiaries. As a result, ITC Holdings' adjusted debt-to-capitalization ratio was about 64% at year-end 2014, while its subsidiaries' ratios were between 20%-40%.

Double Leverage Defined

Double leverage is a financial strategy whereby the parent raises debt but downstreams the proceeds to its operating subsidiary, likely in the form of an equity investment. Therefore, the subsidiary's operations are financed by debt raised at the subsidiary level and by debt financed at the holding-company level. In this way, the subsidiary's equity is leveraged twice, once with the subsidiary debt and once with the holding-company debt. In a simple operating-company / holding-company structure, this practice results in a consolidated debt-to-capitalization ratio that is higher at the parent than at the subsidiary because of the additional debt at the parent.

ITC's parent debt represents approximately 55% of ITC Holdings' total consolidated debt, and our analysis of ITC focuses on the vantage point of the consolidated parent. The substantial amount of holding-company debt in the capital structure drives the two-notch rating differential between ITC and its operating subsidiaries. We note that among US utilities, FERC-regulated transmission operating companies have among the lowest business risk and are sometimes permitted higher amounts of equity in their capital structure than other utilities.

Local natural-gas distribution companies (LDCs) have typically used debt at the parent to infuse equity down to their regulated LDC operating subsidiaries in order to finance capital investments. Two examples are Vectren Corporation (Vectren, not rated) and AGL Resources Inc. (AGL, not rated), which both have large LDC footprints in multiple states as well as other non-utility businesses. Most of the proceeds from Vectren's intermediate holding company, [Vectren Utility Holdings Inc.](#) (A2 stable), and AGL's holding-company debt are used to finance safety and reliability pipeline replacement programs at each of their LDCs, which generally receive timely rate recovery through adjustment mechanisms allowed by regulators.

Regulators Could Take Steps to Mitigate Contagion Risks

Ring-fencing techniques can go a long way toward insulating a regulated utility, as in the case of Oncor (please see the blue box on page 3). But complete protection from an insolvent parent is not guaranteed. Ring-fencing provisions have been used for some time, at least dating back to the 1990s, when Enron acquired [Portland General Electric Company](#) (PGE, A3 stable). The Oregon Public Utility Commission implemented ring-fencing requirements to help ensure that PGE was insulated from Enron's other unregulated operations that eventually led to Enron's bankruptcy. Among these conditions was a requirement to maintain a minimum of 48% equity in the utility's capital structure as well as a requirement that the utility give regulators advance notice of any large dividend payment from the utility to the parent. While PGE's rating was downgraded several notches subsequent to the Enron bankruptcy, the existence of ring-fencing protections helped preserve PGE's investment-grade rating throughout the Enron bankruptcy.

Ring-fencing protections will continue to be considered by regulators, especially when involving M&A activity or when the state regulator becomes concerned about the potential contagion effect on the utility from the parent's unregulated operations or more debt.

Separately, regulators could attempt to influence changes in the capital structure or could adjust a utility's allowed rate of return because of the parent's use of double leverage. However, we have not seen evidence of this in practice. Given the widespread and long-standing use of double leverage across the industry, we do not expect that regulators will attempt to dissuade the use of this financial strategy unless regulators see it harming the utility.

Regulators could also offset the risk of additional holding-company leverage with future benefits to ratepayers by recognizing some or all parent level debt when setting rates. This, too, is uncommon and unlikely, since regulators' purview is typically focused on the

regulated entity and not the parent's capital structure. In addition, it could be difficult to allocate holding-company debt given the complexity of some organizational structures that operate in multi-state jurisdictions and that have unregulated businesses.

Rising Interest Rates Will Increase the Burden on the Family

Rising interest rates will increase refinancing costs at the parent level. Unlike a regulated utility, a holding company can not typically recover rising costs through customer rate increases. A higher interest expense at a leveraged parent that has no other sources of cash flow will further increase the burden on its regulated utility.

Moody's Related Research

Special Comments

- » [Lower Authorized Equity Returns Will Not Hurt Near-Term Credit Profiles, March 2015 \(1003101\)](#)
- » [Adequate regulatory returns and timely cost recovery drive stable outlook..., November 2014 \(177389\)](#)
- » [Wider Rating Differentials Seen for a Number of U.S. Utility and Parent Companies, October 2011 \(136354\)](#)
- » [Proposed Wider Notching Between Certain Senior Secured Debt Ratings and Senior Unsecured Debt Ratings for Investment Grade Regulated Utilities, May 2009 \(116748\)](#)

Outlooks

- » [2015 Outlook - US Regulated Utilities: Regulatory Support Drives Our Stable Outlook, December 2014 \(1000683\)](#)
- » [2015 Outlook - US Unregulated Power: Stable Gas Prices, Declining Reserve Margins Underpin Our Stable Outlook, December 2014 \(1000699\)](#)

Rating Methodologies

- » [Regulated Electric and Gas Networks Rating Methodology, November 2014 \(159570\)](#)
- » [Unregulated Utilities and Unregulated Power Companies, November 2014 \(172784\)](#)
- » [Moody's Regulated Electric and Gas Utilities Methodology, December 2013 \(157160\)](#)

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