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Is State Utility Regulation Coming Back Into Vogue?

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Recent inquiries by regulators suggest U.S. state utility commissions are starting to pay more attention to the relationship between a utility holding company's regulated and nonregulated businesses, likely because of problems experienced by certain diversified energy companies. Coupled with vociferous opposition from western and southern states over FERC transmission initiatives, it appears that utility regulation may be moving to the forefront, which could be beneficial for credit quality at the operating company level.

Talk of isolating a utility from the parent company's unregulated activities could be signaling a trend that greater regulation of utilities is back in vogue, which is quite the opposite of one of the reasons--less regulation--why electric restructuring was instituted. Standard & Poor's Ratings Services has long-held a view of a lack of regulatory insulation from nonregulated operations and diminishing regulatory support for utility credit quality, which has caused many ratings downgrades over the past few years. Therefore, any action that state regulators take that provides support (whether legal, regulatory, financial, or operational) to the utility and/or isolates the utility (most importantly financial obligations) from its parent company will be positive for credit.

Although not all regulated utilities have been affected by the troubles at their affiliate companies, in view of the harsh consequences inflicted on utilities in certain cases, Standard & Poor's believes it is quite likely that state regulators will be placing even greater emphasis on "protecting" the utilities they regulate. For instance, in the ongoing probe of Westar Energy Inc, members of the Kansas Corporation Commission are considering some form of break-up of the company's unregulated and utility operations to protect ratepayers. In Minnesota, during hearings to examine the possible spillover of NRG Energy Inc.'s financial problems onto utility ratepayers, state regulators said they are considering drafting measures at establishing a stronger financial barrier between parent company Xcel Energy Inc.'s regulated and unregulated businesses. Both cases represent a desire by state regulators to protect ratepayers by ensuring the utility is run prudently.

Standard & Poor's view of what constitutes sufficient regulatory insulation has evolved given the ongoing business mix shift by utility holding companies toward nonregulated investments throughout the 1990s. Importantly, ratings are based on the qualitative and quantitative fundamentals of the consolidated entity, not just any one individual subsidiary. Thus, credit ratings

of regulated utility companies are affected by the parent company's nonregulated businesses. Only when sufficient regulatory insulations exists will the corporate credit rating (risk of default) of an operating company be separated from that of the holding company.

In Standard & Poor's view, insulation brought about by legislative statues is a great deal more certain than state utility commission rulemaking and will ultimately provide for greater ratings separation. Notably, most state regulators maintain their state or commission has explicit laws or regulations in place that provide sufficient authority to prevent the financial condition of the utility from being adversely affected by the activities of nonregulated affiliates. However, from a credit perspective, Standard & Poor's believes most of these laws and regulations to be reactive measures; they do not prevent the diversified businesses from weakening the regulated business. These rules typically enable state regulators to take action only after the damage has occurred. Examples of active regulation include measures that meaningfully and timely restrict the flow of the utility's cash to its parent company, such as overhead allocation, loan and dividend restrictions, and stringent equity-maintenance requirements.

State utility commissions are also drawing battle lines against the FERC's effort for some standard market design for the nation's transmission infrastructure. In a Standard & Poor's survey, most state regulators, as expected, feel that the states have the proper jurisdiction over retail transmission, and not the FERC, claiming state oversight provides the best way to oversee transmission issues, including transmission siting. The most important issues confronting state regulation of utilities revolve around transmission--reliability and adequacy, siting, and general regulatory issues. The reliability and transmission adequacy problems experienced by California, Massachusetts, and Illinois, all of which were at the forefront of electric deregulation, have made not just regulators, but also politicians and ratepayers, highly sensitized on how to assure electric reliability in a restructured industry.

Although Standard & Poor's views the future rating trend of the electric industry to be decidedly negative, with insufficient regulated authorized returns and expanding nonregulated investments providing the most downward pressure, the credit quality of electric utilities on a stand-alone basis could show signs of stabilization if they are increasingly sheltered by state regulators. Elevated scrutiny of the general well being of a utility company, specifically its exposure within an energy holding company, indicates a gradual return to stronger utility regulation and could calm the deterioration in credit quality experienced in the industry. This attitude from state regulators, which is quite different from their earlier thinking that a parent's nonregulated activities had little or no impact on the utility company, is absolutely more reasonable. Today, the average power industry credit rating is approximately 'BBB+' versus 'A'/'A-' five years ago, with slightly less than one-half of the industry now carrying a 'BBB' category rating.

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