MOODY'S
INVESTORS SERVICE

INDUSTRY OUTLOOK

US Regulated Electric and Gas Utilities:
Stable Despite Rising Headline Rhetoric

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Our outlook for the investor-owned US regulated electric and gas utility sector is stable. This outlook reflects our expectations for the fundamental business conditions in the industry over the next 12 to 18 months.

- **Our outlook for the US investor-owned regulated electric and gas utility sector is stable.** This outlook is based on our view that supportive regulatory relationships will remain intact, where prudently incurred costs and investments are recovered in a timely manner; that capital markets will remain open and welcoming; and that external cash flow requirements will be financed with a balanced mix of debt and equity.
- **Financing large capital investment programs is a key risk factor to our outlook**. Utilities face a sustained period of outsized capital investment requirements, primarily related to maintenance and environmental compliance. But we've also seen utilities quickly defer or delay discretionary capital investment, in part to mitigate consumer rate shock risks.
- **Capital markets remain open and welcoming**. Utilities continue to enjoy strong access to capital markets, but volatility in the financial institutions sector, and especially European banks, is rising. Should access to capital become limited, it could present a material negative risk to our outlook.
- **The 2012 election cycle will likely bring campaign rhetoric touching on energy policy, infrastructure investment and environmental regulation in the US**. However, we do not expect this to impact credit ratings, as our focus on the political and regulatory environment is primarily at the state and local level.
- **Nevertheless, utilities own and operate critical infrastructure assets, a key ingredient for a functioning economy, and they are major employers in their communities**. This role is not lost on utility management teams whose constituency outreach efforts generally lead to relatively positive regulatory outcomes. Most utilities resemble quasi-governmental tax collecting agents, provide a source of jobs and make timely and sizeable local property tax payments.

Note: Industry outlooks are not explicit signals of the likely direction of ratings in an industry. They are a view of the business conditions that factor into our ratings.

Supportive regulatory relationships remain intact

Today, the vast majority of utilities continue to enjoy healthy relationships with regulators, under which the timely recovery of prudently incurred costs and investments, at a reasonable rate of return, is the norm. As owners of critical infrastructure assets, utilities maintain effective constituent outreach efforts with both regulators and, more importantly, elected officials. The result is evidenced in the regulatory process, where reasonable outcomes underlie our views for low utility default rates and high recovery rates in the event of default. The table below illustrates selected regulatory decisions in 2011:

FIGURE 1

Selected examples of 2011 rate case resolutions

State	Company	Rate Increase ($M)	Return on Equity (%)	Rate Increase Authorized as % of Rate Increase Requested
Missouri	KCP&L Greater Missouri	29.8	10.00	128%
Virginia	Virginia Electric & Power	44.7	12.30	97%
Texas	Southwestern Public Service	52.5	NA	82%
South Carolina	South Carolina Electric & Gas	52.8	11.00	90%
Indiana	Southern Indiana Gas & Elec	28.6	10.40	84%
Missouri	Union Electric	173.2	10.20	82%
Wyoming	PacifiCorp	61.3	10.00	77%
Hawaii	Hawaiian Electric	66.4	10.00	74%
Washington	PacifiCorp	33.5	9.80	70%
Delaware	Delmarva Power & Light	16.4	10.00	68%

NOTE: Rate increases may include fuel and other rider recovery

Source: SNL

We see a sustained pace of more frequent requests for rate relief, and an increasing trend for special, single-issue rate riders and/or trackers as part of the overall rate recovery structure. We view single issue rate riders as a net credit benefit, primarily due to the increased transparency associated with recovery[1].

Rate shock and consumer affordability still a key risk factor

Most utility management teams are very successful in managing consumer rate shock pressures. We see this competency being tested over the next few years, as utilities look to implement annual rate increases of approximately 3% - 5% in the presence of a prolonged weak economy, characterized by high unemployment, low wage inflation and widening income inequality. Should rate increases reach the point where wide-ranging consumer dissatisfaction leads to more contentious regulation (the "inflection point"), the entire sector could be negatively affected. A much larger risk lies in the potential for political intervention, which we see as a more unpredictable and severe event risk, accompanied by material unintended consequences.

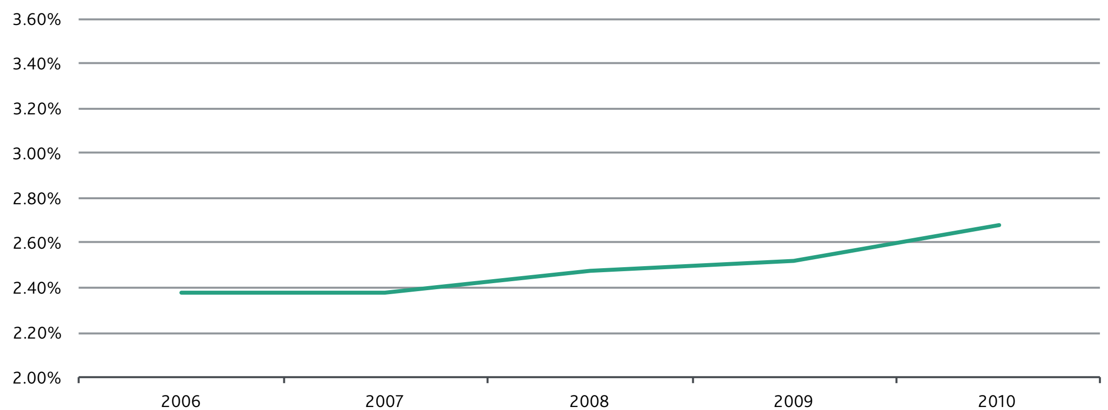
[1] See Decoupling and 21st Century Rate Making, November 2011 (136797)

Although we see no signs of wide ranging contentiousness at this time, we have seen recent evidence that our "inflection point" has been breached in several local jurisdictions[2]. To date, utilities have been adept at managing the consequences without materially harming their credit profile.

Prospectively, we will continue to monitor the landscape for signs indicating a rise in regulatory contention. These signs could include a material increase in litigated rate cases (as compared with settlements), more lengthy (or less timely) recovery periods, and sizeable increases in deferred assets. Our assessment is not likely to be materially affected by any heightened political rhetoric emanating from the US presidential election cycle, since we will focus primarily on the local level.

FIGURE 2

Illustrative Inflection Point Risk
(Average US annual residential electric costs / Median income)



EIA & Economy.com

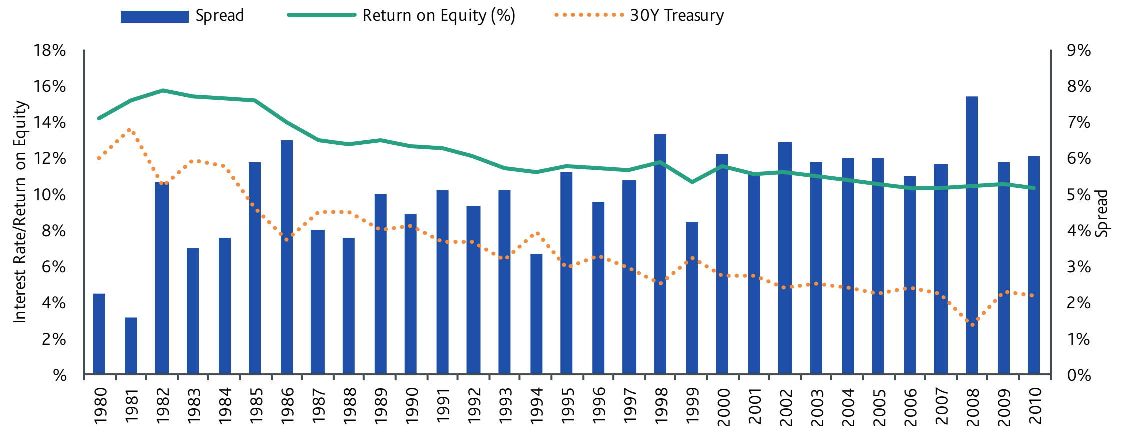
Declines in authorized return on equity rates expected to accelerate

Over the next two years, we see regulatory commissions scrutinizing authorized returns on equity (ROEs) more closely, in part due to the spread between authorized ROEs and the risk-free, long term US Treasury yield. In addition, many regulators appear to be increasingly questioning the overall risk profile of utilities, which enjoy authorized recovery (through base rates and riders) for the vast majority of their operating costs and infrastructure investment requirements.

We see authorized ROEs continuing a downward trajectory over the next few years, offset by depreciation, amortization, and tax strategies. Although we do not attribute a material weighting in our methodology to authorized ROEs by themselves, they represent a leading indicator of longer-term regulatory support and potential earnings power.

[2] Some examples include Virginia, Ohio, Illinois, Maryland, Hawaii

FIGURE 3
Authorized Return on Equity & 30 Year US Treasury yield



SNL & Bloomberg:

FIGURE 4
Authorized ROEs Don't Always Correlate to Earnings and Cash Flow

	Issuer Rating / Senior Unsecured	Outlook	CFO Pre-W/C / Debt 2010	CFO Pre-W/C / Debt 2002 - 2010 Average	Latest Authorized ROE	Earned, Adjusted ROEs 2010	Earned, Adjusted ROEs 2002 - 2010 Average
Historically More Supportive Regulatory Environments							
Florida Power & Light Company	A2	Stable	27.5%	39.6%	10.00%	10.32%	10.14%
Virginia Electric and Power Company	A3	Stable	21.5%	21.7%	10.70%	10.39%	9.84%
Georgia Power Company	A3	Stable	21.5%	21.3%	11.15%	10.30%	10.69%
Historically Less Supportive Regulatory Environments							
Arizona Public Service Company	Baa2	Stable	24.5%	20.5%	11.00%	8.72%	7.78%
Public Service Company of New Mexico	Baa3	Stable	17.9%	16.3%	10.00%	4.61%	2.14%
Commonwealth Edison Company	Baa3	Stable	19.6%	18.8%	10.50%	4.76%	5.16%
Nevada Power Company	Ba1	Stable	15.7%	12.7%	10.19%	6.46%	3.02%

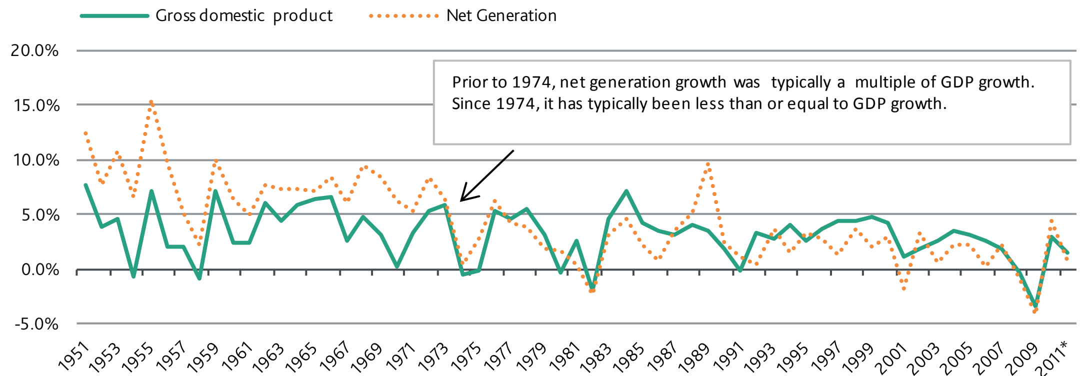
Source: Moody's MFM (Earned, Adjusted ROEs)

Tempered volume growth expectations

A sector-wide reliance on rising volume growth represents a risk factor to individual issuers and the industry as a whole. Specifically, if volume growth does not materialize as projected, utilities will be faced with a more difficult regulatory strategy with respect to their overall rate structure and prospects for recovery of invested capital. This issue of lower volume projections is expected to take on more prominence given the sizeable capital investment decisions that are currently being made, for instance with respect to environmental compliance, replacement of older plants with more efficient/compliant units and transmission upgrades.

While a weak economic scenario is probably the biggest risk to volume growth, we also see risks rising from a steady improvement in energy efficiency programs, which have produced sizeable volume reductions in the public power sector.

FIGURE 5
Growth in GDP versus Net Generation

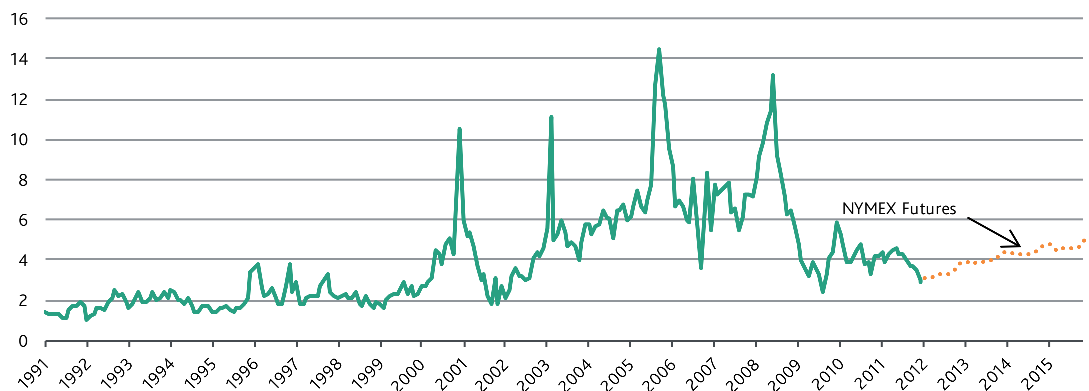


Source: EIA & U.S. Bureau of Economic Analysis

Sustained period of low natural gas and power prices benefit utilities

We see a sustained period of relatively low natural gas and power prices, a material credit positive. Regulated utilities generally benefit from falling fuel and power prices because they may be able to offset base rate or other rate rider increases (which can include a profit margin) with reductions in the fuel cost pass-through trackers (which typically exclude any margin opportunities) while keeping all-in rates relatively steady. Natural gas prices are viewed as a key indicator for power prices in many regions of the US, so the benefit of a sustained period of relatively low natural gas prices will be felt broadly, even in regions which tend to be dominated by coal prices on the margin. In addition, we see good liquidity implications associated with lower fuel and purchased power bills.

FIGURE 6
Henry Hub Natural Gas Spot Price and NYMEX Futures



Source: Bloomberg

This favorable pricing scenario could have an unpleasant corollary when it reverses. Consumers, who are indifferent to the components of their electric rates, will become accustomed to the size of their monthly bills, which have only increased modestly as large rate base increases have been offset by falling fuel prices. Should fuel and commodity costs rise, utilities will face growing underfunded fuel balances or potential rate shock issues when they seek to recover the higher costs. Liquidity profiles

could become strained. Our 12-18 month view does not incorporate an expectation of such a pricing reversal.

Environmental compliance mandates will keep capital expenditures high

We see a sustained investment need over the next three to five years, in part to address increasingly stringent environmental compliance mandates associated with fossil-fired generation assets. Regardless of whether the capital investment is required for maintenance, compliance or growth, from a credit perspective the expanded capital investment program will contribute to a more challenging business environment for utilities, especially those issuers that primarily rely on debt financing. Over the longer term horizon, capital investment in utilities' rate base is viewed positively, but the benefits could be offset by a more leveraged capital structure or overly biased shareholder reward programs.

Recent US Environmental Protection Agency (EPA) regulations add to the rising capital investment trajectory, but for regulated utilities we see very little risk associated with recovery at this time. In our opinion, regulated utilities are better positioned to manage the costs associated with increasingly stringent environmental mandates than are unregulated power companies. For example, regulated utilities can address their compliance strategy on a fleet-wide basis, enjoy a more transparent recovery path and can amortize their investment decisions over a longer period of time. In contrast, unregulated power companies are more likely to make plant-by-plant investment decisions, principally based on shorter-term forward commodity curves. They lack the benefit of a regulated generation fleet and are forced to recover their investments through market prices[3].

With respect to recent and pending EPA regulations, we see most utilities as very well positioned to address the increasingly stringent mandates, while others appear more exposed and caught off-guard. Even among the most vocal objectors, we observe that many of their larger, more critical coal-fired generation plants are already compliant, after installation of environmental controls over the past decade.

Given that environmental issues have long been politically divisive, we see the EPA as a reasonably transparent regulatory agency, where regulations have been proposed and implemented on a regular basis over the past few decades. We continue to incorporate a view that utility management teams maintain a deep understanding of environmental regulations, including the potential risks of pending regulations. In addition, we continue to observe that the EPA's increasingly stringent regulations produce a steady stream of rate base growth for utilities, a credit positive. Nevertheless, these regulations are complex, and accompanied by a rising operating cost structure and higher capital investment requirements. These higher costs could pressure consumer affordability risks and our inflection point.

Consolidation activity poised to increase

Utility consolidation and merger activity will likely increase over the next 2 years. Strategically, the industrial logic behind consolidating a homogenous, highly fragmented sector and spreading fixed costs across a wider asset platform is difficult to challenge. Moreover, regulatory authorities appear more open and willing to facilitate utility consolidation, especially if the merger results in a lower trajectory of rate increases. Today, the biggest regulatory challenges appear to revolve around head-count reductions and the location of the headquarters building. Less critical is the identification and allocation of projected cost synergies[4].

3 See Credit Implications Associated with Increasingly Stringent Environmental Regulations, November 2011 (136831)

4 See Credit Quality Emphasized More in Recent US Utility M&A, November 2011 (136790)

The biggest impediment to further consolidation, in our opinion, is the selection of the Chief Executive Officer, followed by the equity accretion analysis. Utilities with older, retiring CEOs or CEOs willing to relinquish their role are considered the most ripe for consolidation activity. We also see consolidation as a means to create scale and scope, and to diversify geographical and industrial exposure and regulatory jurisdictions. Nevertheless, even the largest US utilities pale in comparison to the size of their European counterparts.

FIGURE 7

Key Financials for Selected US Utilities and EMEA Utilities

Company	Rating	Outlook	Assets	Debt	Revenue
Largest U.S. Utilities - LTM 9/30/2011					
Duke Energy / Progress Energy	Baa2	Stable	95,794,860	35,242,860	24,097,000
Exelon Corp. / Constellation Energy	Baa1	RUR-Down	75,095,600	33,353,700	24,287,900
Southern Company	Baa1	Stable	58,385,000	22,278,000	17,732,000
NextEra Energy, Inc.	Baa1	Stable	56,510,000	21,784,000	14,890,000
Edison International	Baa2	Stable	53,801,000	21,719,000	12,816,000
American Electric Power Company	Baa2	Stable	53,192,000	20,781,000	15,106,000
FirstEnergy Corp.	Baa3	Stable	48,879,553	21,360,553*	15,528,000
PG&E Corporation	Baa1	Stable	47,596,974	15,397,724	14,762,000
MidAmerican Energy Holdings Co.	Baa1	Stable	46,930,000	20,934,000	11,107,000
Dominion Resources Inc.	Baa2	Stable	44,941,000	20,326,750	14,947,000
Largest EMEA Utilities - LTM 9/30/2011					
Company	**Rating**	**Outlook**	**Assets**	**Debt**	**Revenue**
Electricite de France**	Aa3	Stable	327,807,728	85,528,388	88,773,997
GDF SUEZ SA**	A1	Stable	307,718,962	86,671,596	119,759,315
ENEL S.p.A.**	A2	RUR-Down	244,758,094	101,152,625	102,132,853
E.ON AG	A2	RUR-Down	195,553,588	44,022,702	148,439,207
Iberdrola S.A.* * *	A3	Stable	134,722,752	73,595,465	41,313,682
RWE AG	A2	Negative	100,155,710	50,020,198	70,186,831
Vattenfall AB	A2	Stable	77,011,771	28,142,162	28,655,904
Gas Natural SDG, S.A.	Baa2	Stable	61,715,134	28,825,906	28,808,902
Energias de Portugal, S.A.	Baa1	Negative	54,165,269	28,731,392	21,051,642
Fortum Oyj	A2	Stable	28,961,243	11,073,625	8,920,495

* FirstEnergy's consolidated revenue reflects the merger with Allegheny Energy effective 2/25/2011.

** LTM as of 6/30/2011

*** LTM as of 3/31/2011

Transmission infrastructure remains fragmented, keeping costs high and benefits locked up

The US transmission infrastructure remains disjointed, with multiple oversight authorities and parochial protectionism. As a result, utilities do not fully coordinate their individual transmission investment projects to the benefit of wider audiences. Instead, large high-voltage projects tend to be favored by Regional Transmission Organizations (RTOs) or Independent System Operators (ISOs), while smaller, local solutions tend to be favored by local and state political and regulatory interests. Nevertheless, we believe additional transmission-only activity is poised to become a bigger issue in 2012 and beyond.

The Federal Energy Regulatory Commission (FERC) continues to provide incentive returns for interstate transmission, but we question how long this incentive can last. For example, we believe the recent transaction between Entergy and ITC Holdings could provide a catalyst for more scrutiny regarding the impact on local consumer rates.

But aside from FERC and the larger projects, we have seen a considerable amount of transmission congestion relief, characterized by smaller, local projects emerging from the consolidation of two neighboring systems - such as when FirstEnergy acquired Allegheny. We expect similar benefits to emerge if the merger of Duke Energy and Progress Energy is completed.

Financial profile benefits from tax policies, but equity needs are calling

Utility financial profiles exhibit good stability, despite the pressures of a weak economic environment. Cash flows have been higher in recent years, even though revenues have yet to return to pre-recession levels. This is primarily due to the windfall benefit of federal tax policies, especially with respect to bonus depreciation[5].

The effects of bonus depreciation are temporary, in our opinion, since they essentially represent a borrowing of future cash flow. As a result, we will continue to analyze the impact of this benefit on utilities' cash flow credit metrics to gain a more accurate view of fundamental performance.

Eventually, all else being equal, utilities will need to inject sizeable amounts of equity into their capital structures. Based on our simple projections for revenue growth, cash flow, capital expenditures and dividends, we see the utility sector remaining in a state of sizeable negative free cash flow for the next several years. If the recently exhibited bias to finance this shortfall primarily through borrowing continues, our key credit metrics will eventually exert pressure on the rating.

5 See US Investor-Owned Utilities: Bonus Depreciation Provides Material Near-Term Benefit For The Sector But Raises Longer-Term Questions, February 2011 (131078) and US Utility Cash Flow Ratios Less Robust Than They First Appear, November 2011 (136794)

Conclusion

Today, the US investor-owned utility sector benefits from the nature of its critical infrastructure assets; a supportive and constructive regulatory environment; welcoming capital markets; and stable-to-slightly improving financial profiles. Liquidity availability remains strong, evidenced by multi-year syndicated facilities with modest covenant terms replacing expiring facilities, albeit at a slightly higher cost.

We see a headline-heavy year in 2012 due to the expected rhetoric associated with the November elections. With a sputtering economic recovery in the background, the rhetoric is likely to include posturing on increasingly stringent environmental regulations, the need for capital investment to refurbish electricity infrastructure, federal loan guarantees and other tax credit policies, nuclear generation, renewable energy, energy efficiency and cyber security.

We have been highlighting many of these longer-term risks for several years, always focusing on the potential emergence of increased regulatory contention or political intervention. Although these risks have not yet risen to an alarming trend, they are appearing on our radar screen more frequently. To date, the credit implications have been manageable. As always, we will endeavor to look through the rhetoric and remain focused on credit fundamentals.

Appendices – Select Financial Data by Subsector

Appendix A: Selected Parent Holding Companies

Company Name	Issuer or Sen. Unsec. Rating
Ameren Corporation	Baa3
CenterPoint Energy, Inc.	Baa3
Consolidated Edison, Inc.	Baa1
Dominion Resources Inc.	Baa2
DTE Energy Company	Baa2
Duke Energy Corporation	Baa2
Edison International	Baa2
Entergy Corporation	Baa3
FirstEnergy Corp.	Baa3
NextEra Energy, Inc.	Baa1
Northeast Utilities	Baa2
Pepco Holdings, Inc.	Baa3
PG&E Corporation	Baa1
PNM Resources, Inc.	Ba1
PPL Corporation	Baa3
SCANA Corporation	Baa3
Sempra Energy	Baa1
Southern Company (The)	Baa1
Wisconsin Energy Corporation	A3
Xcel Energy Inc.	Baa1

Appendix B: Selected Integrated Companies

Company Name	Issuer or Sen. Unsec. Rating
Alabama Power Company	A2
Appalachian Power Company	Baa2
Columbus Southern Power Company	A3
Duke Energy Carolinas, LLC	A3
Duke Energy Indiana, Inc.	Baa1
Entergy Arkansas, Inc.	Baa2
Entergy Mississippi, Inc.	Baa3
Florida Power & Light Company	A2
Georgia Power Company	A3
Indiana Michigan Power Company	Baa2
Kansas City Power & Light Company	Baa2
Mississippi Power Company	A2
Northern States Power Company (M	A3
Oklahoma Gas & Electric Company	A2
Pacific Gas & Electric Company	A3
Portland General Electric Company	Baa2
Public Service Company of New Me	Baa3
Union Electric Company	Baa2
Virginia Electric and Power Company	A3
Wisconsin Electric Power Company	A2

Appendix C: Selected Transmission & Distribution Companies

Company Name	Issuer or Sen. Unsec. Rating
AEP Texas Central Company	Baa2
Ameren Illinois Company	Baa3
Baltimore Gas and Electric Company	Baa2
CenterPoint Energy Houston Elect	Baa2
Cleveland Electric Illuminating	Baa3
Connecticut Light and Power Company	Baa1
Consolidated Edison Company of N	A3
Delmarva Power & Light Company	Baa2
Duquesne Light Company	Baa2
Jersey Central Power & Light Company	Baa2
NSTAR Electric Company	A1
Ohio Edison Company	Baa2
Oncor Electric Delivery Company	Baa1
PECO Energy Company	A3
Pennsylvania Electric Company	Baa2
Potomac Electric Power Company	Baa2
Superior Water, Light and Power	Baa1
Toledo Edison Company	Baa3

Moody's Related Research

Industry Outlooks:

- U.S. Coal Industry: U.S. Coal Producers Lean on Export Markets Amid Challenges at Home, December 2011 (137742)
- EMEA Electric and Gas Utilities: Industry Outlook 2011, November 2011 (137305)
- Outlook Update: Global Integrated Oil & Gas Industry: Moderation in Oil Prices and Pressure on Downstream Activities are Likely to Dampen Earnings Growth in 2012, September 2011 (136270)
- Six-Month Update: U.S. Regulated Utilities – Stable Outlook But Financial Policy Revisions Increasingly Necessary to Maintain Ratings Amid Persistent Longer-Term Uncertainty, July 2011 (134002)
- Annual Industry Outlook: Global Integrated Oil and Gas Industry: Elevated Crude Oil Prices and Asset Disposals Support Investment Efforts, June 2011 (134051)
- Annual Outlook: U.S. Power Companies – Regulation Provides Stability As Risks Mount, January 2011 (129930)

Special Comments:

- Oil and Natural Gas: High Prices to Keep Oil Production Brisk in 2012, Helping Midstream and OFS Sectors, January 2012 (138669)
- U.S. Utility Cash Flow Ratios Less Robust Than They First Appear, November 2011 (136794)
- Credit Implications Associated with Increasingly Stringent Environmental Regulations, November 2011 (136831)
- Decoupling and 21st Century Rate Making, November 2011 (136797)
- Riders on the Storm: Utility Sector Ratings Well Insulated from Severe Weather Impacts, November 2011 (136820)
- Credit Quality Emphasized More in Recent U.S. Utility M&A, November 2011 (136790)
- Rise in Utility Unfunded Pensions Are Credit Negative, October 2011 (136505)
- Wider Rating Differentials Seen for a Number of U.S. Utility and Parent Companies, October 2011 (136354)
- U.S. Investor-Owned Utilities: Bonus Depreciation Provides Material Near-Term Benefit For The Sector But Raises Longer-Term Questions, February 2011 (131078)

Rating Methodologies:

- Regulated Electric and Gas Utilities, August 2009 (118481)
- Unregulated Utilities and Power Companies, August 2009 (118508)
- Natural Gas Pipelines, December 2009 (121678)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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