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Corporates

U.S.

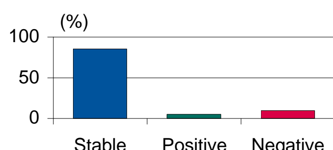
# 2012 Outlook: Utilities, Power, and Gas

Crosscurrents
Outlook Report

**Rating Outlook**
**Utility Parent Companies**
**STABLE**

**Investor-Owned Utilities — Electric and Gas**
**STABLE**

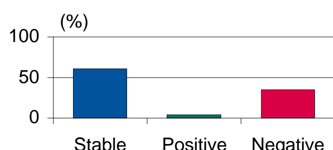
**UPC and IOU Sector Outlooks**




Source: Fitch Ratings.

**Competitive Generators**
**NEGATIVE**

**Competitive Generation Companies Sector**




Source: Fitch Ratings.

**Related Research**

What a Difference a Summer Makes … in ERCOT, Nov. 18, 2011

Heating Season Update 2011–2012 — Modest Price Increases and Warmer Weather Expected to Keep Costs in Check, Oct 28, 2011

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## Rating Outlook — Investor-Owned Utilities and Parent Companies

**Favorable Operating Environment:** Operating and market conditions are expected to remain favorable in 2012 for investor-owned utilities (IOUs) and utility parent companies (UPCs), driven by good capital markets access, low interest rates, and low natural gas prices.

**Risk Factors Present:** UPCs with competitive generation subsidiaries and regulated utilities with wholesale power sales continue to face a challenging environment, with most regional power markets suffering from excess capacity and weak power prices. Managing through an extended period of high capital investment is the other principal risk to bondholders, should adequate and timely returns on investment not be authorized.

**Economic Backdrop:** Within the broader context of a sustained but modest U.S. economic growth forecast for 2012, company credit profiles and ratings are expected to remain stable. Industry consensus forecasts for a slight decline in electricity sales in 2012 are largely due to strong weather-related sales in 2011.

**Divergence Expected:** Integrated electric utilities have higher risk profiles than transmission and distribution (T&D) electrics and gas utilities, reflecting their exposure to new power-generation builds or environmental upgrades of existing facilities. UPCs with diversified activities also exhibit a higher risk profile than those with a pure regulated model.

## Rating Outlook — Competitive Generators

**Negative Credit Outlook**: The operating environment is expected to remain challenging for the competitive generators (gencos) given the slow recovery in power prices, tightening environmental regulations, and choppy capital markets. Uncontrolled coal generation in markets where natural gas is on the margin is especially vulnerable. Unlike the pure play generators, affiliated gencos may benefit from strong parent or affiliate linkages.

**No Relief from Gas Prices**: The natural gas price forward curve continues to shift lower, and consensus price forecasts have been lowered for both prompt and outer periods. This, coupled with sluggish demand, has conspired to keep power price recovery from the 2009 lows modest.

**Longer Term Outlook Brighter:** Fitch Ratings expects power market recovery to gradually accelerate as coal-fired generation retirements bring supply more in line with demand, although timing varies by market. Fitch believes Texas could turn around the earliest, as evidenced by the spikes in power prices during the prolonged 2011 summer heat wave.

## What Could Change the 2012 Outlook

**Capital Markets Freeze:** Significant tightening or loss of capital markets and bank access would have a deleterious affect on sector creditworthiness in the face of high capex budgets.

**Double-Dip Recession:** Weaker than projected economic growth would further erode prospects for weather-adjusted electricity sales, which Fitch expects to be essentially flat in 2012. In such an event, ratings of companies with Negative Outlooks, or exposure to wholesale power markets, could be downgraded.



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## What Could Change the Two- to Five-Year Outlook

The utilities, power, and gas sector is characterized by investment decisions, regulatory frameworks, and rules and regulations that are planned and implemented over a multi-year time horizon. Credit factors over this longer term time period include the following.

### Secular Flattening in Electricity Sales

There is growing evidence that longer term consensus forecasts of electricity sales growth of 1%–2% per annum may be optimistic. Technological and manufacturing improvements in lighting, heating, and air conditioning systems, along with smart meter, thermostatic, and software interfaces, have the potential to reduce electricity consumption growth to flat to +1% over the next two to five years, in Fitch's opinion. Even a small decline in electricity sales growth rates can be harmful to the industry's credit profile, as higher costs are spread over fewer units of sales and would require more frequent rate relief. Unlike other renewable energy sources, the economics of conservation investments is compelling, with cost savings providing relatively short payback periods.

Many large commercial consumers of electricity are pursuing efficiency and conservation programs outside the traditional utility channels. Many big box retailers and commercial real estate owners are in the early stages of energy efficiency programs that will significantly reduce their power-consumption needs.

### Natural Gas Price Shocks

The power sector is becoming addicted to low natural gas prices, and the generation mix will increase from approximately 25% gas-fired generation in 2011 to almost 40% by 2025, according to most industry forecasts. While some uncertainty exists as to the ultimate supply of shale natural gas due to lingering environmental concerns, given prospects for substantially increased domestic demand and exports of liquid natural gas, a more balanced supply-demand picture will likely result in higher natural gas prices. Higher gas prices will raise power prices and customer bills, possibly stimulating further conservation efforts.

### Environmental Effects Unknown

Implementation of the Environmental Protection Agency's (EPA) Cross-State Air Pollution Rule (CSAPR) in 2012 will be a wild card, and will leave a clear mark on power markets in the regions affected. The EPA's Mercury Air Toxics Standard is to take effect in 2015 or 2016, and compliance costs are expected to be high. Capital costs to remediate a typical 500-MW coal-fired plant can run approximately $800,000 per MW for a total cost of approximately $400 million. The per-MW cost is even higher for smaller coal-fired units. Many operators will simply chose to shut their plants, especially owners of older inefficient plants, rather than incur such a large capital cost with uncertain return on investment.

On the operating side, in the absence of an established emission credit trading market, environmental compliance costs are uncertain and difficult to quantify. Financial penalties under CSAPR for exceeding state limits will not be applied until Jan. 1, 2014. In the interim, companies will be implementing strategies to comply with emission reductions that will include substantial increases in environmental capex, plant closures, and higher operating expenses from fuel switching or blending. Given the many uncertainties, the known and unknown financial and strategic implications of CSAPR will weigh on the power sector.



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The national elections in November 2012 may represent a referendum on many issues of concern, including environmental rules and policies. A change in administration may cause a postponement, change, or elimination of impending rules by the EPA.

### Company-Specific Strategies or Developments

For individual companies, rate case outcomes, shifts in corporate strategy, and merger and acquisition activity are the most likely causes for an outlook change. Event risks, such as forced plant outages, storm damages, or extreme weather could also trigger an outlook revision. Fitch does not consider shareholder activities involving treasury share buybacks to be a primary concern, but would be a source of rating pressure if enacted.

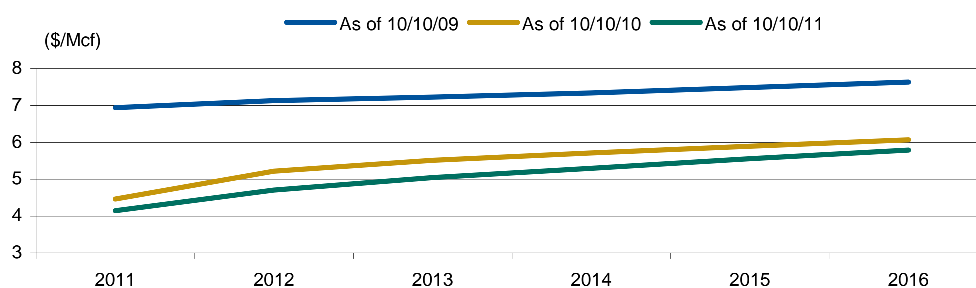
Fitch expects greater divergence for competitive gencos over time, reflecting regional power market, fuel mix, and environmental exposures. Gencos situated in the Electric Reliability Council of Texas (ERCOT) region and operators with natural gas or scrubbed coal fleets are best positioned.

## Key Issues and Drivers of the Outlook

### Natural Gas, Power Prices, and Electricity Sales

Abundant supplies and sustained low prices of natural gas are having a transforming effect on the entire utilities, power, and gas sector. However, subsectors and individual companies are correlated to natural gas differently. Regulated utilities, T&D electrics, and gas distributors generally benefit the most from low natural gas prices, which have the concomitant beneficial effect on customers through lower prices for power, and keep customer bills affordable.

**Natural Gas Forward Prices — Henry Hub**




Mcf – Thousand cubic feet.
Source: Fitch Ratings, Bloomberg.

Power prices increase only gradually in Fitch's financial models and forecasts, reflecting the dampening effect of low natural gas prices and excess reserve margins. Fitch's power market consultant, Wood MacKenzie, also projects a slow increase in power price through 2015, although prices remain below pre-2008 recessionary levels.

Low natural gas prices tend to depress wholesale power prices for gencos, particularly in markets where natural gas is on the margin. Low natural gas prices improve the mid-merit dispatch of gencos with large natural gas fleets, resulting in higher capacity utilization.

Consensus forecasts are for 2012 electricity sales to decline slightly from 2011 levels due largely to favorable weather patterns in 2011, and to a lesser extent, continued weak economic



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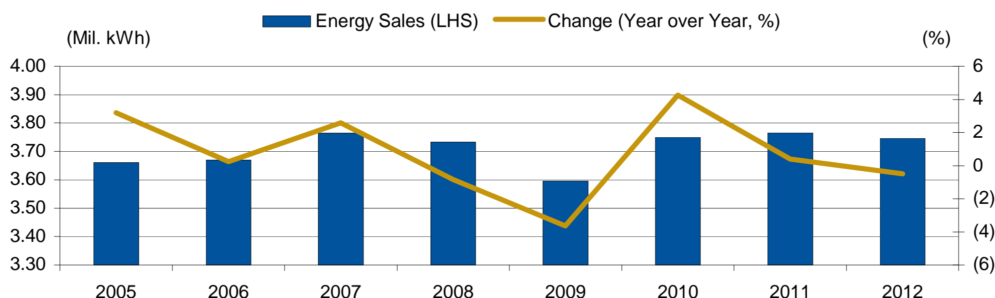
growth. Electricity sales are projected to be essentially flat when adjusted for weather. Efficiency and conservation programs will also dampen electricity sales growth, in Fitch's opinion. Longer term, lower sales will result in higher unit costs, which impede margins for individual utilities and require more frequent rate relief. The modestly lower sales forecasts in 2012 will largely be offset by earnings from capex projects, which have been completed and entered into the rate base.

**Power Consumption Trends**

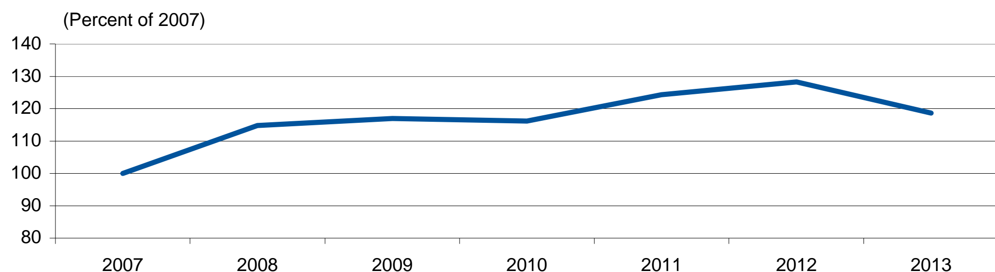



Source: E.I.A.

## High Capex with Reliance on External Financing

Capex is expected to remain robust in 2012. Fitch projects capex to increase 5.7% in 2012, in addition to increases of 6.4% in 2010 and 4.6% in 2011. High capex typically places stress on credit metrics and bond spreads. However, bonus depreciation and low financing costs have ameliorated most of the cash flow pressures from high capex. Many investments such as transmissions projects under the Federal Energy Regulation Commission jurisdiction also enjoy timely recovery through construction work in progress (CWIP) tariffs. Consequently, during this capex period, earnings and credit quality have not been negatively affected.

**Capital Expenditures**




Source: Fitch Ratings.

Fitch expects the regulated utility sector to enjoy a continuation of strong capital market and bank access, along with favorable pricing similar to 2011. Financing costs for long-term first mortgage bonds are at historic lows, reflecting the defensive nature of the regulated utility sector. Investors have demonstrated a strong appetite for utility paper, given a general risk



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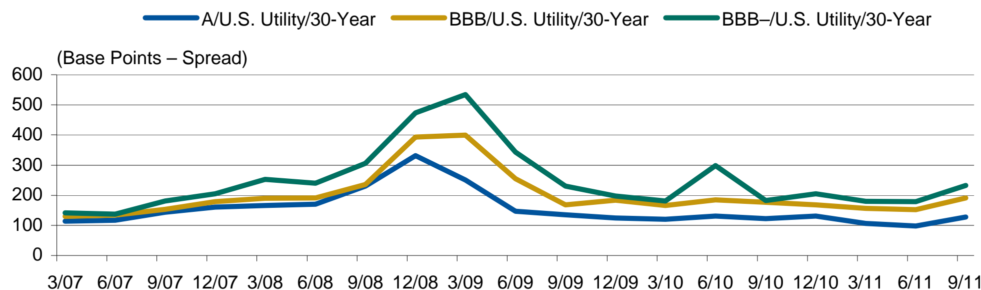
aversion among institutional and retail investors. Gencos face a more challenging environment, particularly high-yield issuers. Fitch expects non-investment grade issuers will face difficult market conditions given continued economic uncertainty.

**Spread Over 30-Year Treasury by Rating Category**




Source: Bloomberg.

## Regulatory Actions

Fitch sees continued downward pressure on authorized return on equity (ROE), which has moved lower over the last couple of years, from around 10.5% to approximately 10%, according to a recent Fitch study. Regulators' decisions in rate cases remain a key credit factor for regulated utilities. The political and regulatory environment affecting regulated utilities varies state by state.

## Economic Stimulus Expiry

The utilities, power, and gas industry was a primary beneficiary of the various economic stimulus packages, including bonus depreciation and investment tax credits put in place over the last few years. Cash flow, particularly funds from operations (FFO) measures, has been particularly robust in 2010 and 2011. With the bonus depreciation phase-out starting in 2012, and full expiration of such incentives in 2013, Fitch expects cash flow measures to revert to pre-2008 normalized levels.

## Stringent Environmental Rules

The EPA issued CSAPR on July 7, 2011. The rule is effective Jan. 1, 2012, essentially covers the eastern half of the U.S., including Texas, and mandates substantial reductions in power plant emissions. Emission reductions vary by state. Fitch considers 80 gigawatts of coal capacity at risk for closure as a result of the rule.

## Mergers and Acquisitions (M&A)

Fitch expects continued consolidation in the industry. However, Fitch feels the rating implications are limited, since existing ratings for most of the larger utility holding companies fall within a narrow band, and mergers are typically consummated using stock as currency. For operating subsidiaries, little rating effect would be expected among large traditional utility combinations. Rating risk would be present in combinations where the acquirer is a merchant



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genco (such as DPL Inc.'s acquisition by AES Corporation), or where the acquirer is a nonstrategic or private equity firm.

Consolidation among gencos is also likely driven by the need for regional diversity, high environmental capex requirements, and the desire to gain necessary size and scale.

## 2011 Review

For the utilities, power, and gas sector, 2011 could best be described as the quiet before the storm. Despite many headline news events, including the adoption of new EPA rules, reduced economic growth forecasts, record low interest rates, and further reductions in natural gas prices and forward curves, the industry performance was largely on par with 2010 and within Fitch's, and general industry consensus, expectations.

The Fukushima Daiichi nuclear accident on March 11, 2011, left an indelible mark on the future of nuclear energy globally. Nuclear power supplies approximately 20% of total U.S. power consumption, and is a relatively cost-effective source of low-emitting generating capacity. Fitch believes the strong safety-oriented oversight by the Nuclear Regulatory Commission, the power and utility industry's generally favorable safety record, and the importance of nuclear in managing system load support the continued operation and relicensing of such facilities. Higher capex for safety upgrades and resultant higher operating costs are not expected to alter the favorable generation profile of the existing nuclear fleet.

The future of new nuclear development in the U.S. is problematic. A few utilities are pursuing nuclear development within regulated rate base and strong tariff recovery mechanisms. Forward market prices do not support nuclear development on a merchant basis.

Enactment of a comprehensive national energy power policy again proved elusive, reflective of a general political stalemate and lack of leadership in Washington, which will likely persist through the presidential elections in November 2012. Strategic planning of long-term capital investments is increasingly problematic, particularly in relation to environmental upgrades and renewable and other forms of new generation.

## Median Ratings and Rating Activity

Median senior unsecured ratings for parent holding companies and their regulated operating subsidiaries have remained stable over the last few years at 'BBB' and 'BBB+', respectively. Within the relative safety of higher electricity sales, low interest rates, and low natural gas prices, 2011 rating activity within Fitch's regulated utility portfolio was muted, but biased to upgrades and Positive Outlook revisions.

Gencos did not enjoy such security, as lower wholesale power prices continued to pressure margins, resulting in a large number of rating downgrades and Outlook revisions to Negative. Within the merchant rating portfolio, affiliated gencos have tended to face less pressure and largely retain investment-grade ratings, with the notable exception of Edison Mission and related entities. Independent power producers, (IPPs) tend to have non-investment grade ratings.

### Utilities, Power and Gas Rating Activity — 2011

| | Upgrades | Downgrades |
|---|---|---|
| UPCs | 4 | 5 |
| IOUs | 16 | 6 |
| Gencos | 1 | 11 |

UPC – Utility parent companies. IOU – Investor-owned utilities.
Source: Fitch Ratings.



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There was no particular pattern or trend among the 2011 upgrades for utility parent companies (UPCs). Among the regulated companies upgraded in 2011, seven are part of the First Energy family following consummation of the merger with Allegheny. Other upgrades include Westar and Kansas Gas & Electric, which continues to recover from earlier stresses, and Oncor, the regulated subsidiary of Energy Future Holdings (EFH). Three gas local distribution companies (LDCs), Atmos Energy, Southwest Gas, and Mountaineer Gas, were upgraded.

The first major casualty of depressed wholesale power market conditions was Dynegy Holdings, Inc., which filed bankruptcy in November 2011. Other notable rating downgrades within Fitch's merchant genco portfolio included EFH and subsidiary Texas Competitive Energy Holding, and genco affiliates of Ameren and Edison International.

## M&A Activity and Consolidation

The case for continued industry consolidation remains strong given the fragmented structure of the industry. Drivers of consolidation include the scale of capital investments needed relative to the book capital and market capitalization of individual companies, strategic synergies, particularly in competitive activities, and operational cost savings. The regulatory structure typically requires a one-year or longer timeframe to complete combinations of UPCs and IOUs.

### Major Merger and Acquisition Announcements — 2011

($ Mil.)

| Buyer | Seller | Target | Price | Valuation |
|---|---|---|---|---|
| Duke Energy Corp. | Progress Energy, Inc. | Progress Energy, Inc. | 25,700 | 8.6x EBITDA |
| AES Corp. | DPL Inc. | DPL Inc. | 4,600 | 7.5x EBITDA |
| Exelon Corp | Constellation Energy Group | Constellation Energy Group | 10,600 | 7.6x EBITDA |
| Fortis Inc. | Central Vermont PS | Central Vermont PS | 702 | 7.1x EBITDA |
| PPL Corp. | E.ON UK plc | Central Networks UK | 5,600 | Not Disclosed |

PS – Public service.
Source: Fitch Ratings.

Gencos face similar pressures to combine. Prior to Dynegy Holdings' bankruptcy filing, two separate merger agreements collapsed in the face of shareholder opposition.

Fitch expects the M&A pace to continue into 2012.



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## 2012 Credit Outlook Summary by Sub-Sector

The segment credit outlooks in the left column reflect fundamental analysis of factors influencing developments in the sub-sectors, not the aggregate Rating Outlooks of the entities. Median ratings indicated are based on the IDRs of entities rated by Fitch Ratings.

| Segment | Key Trends and Credit Issues for 2011 |
|---|---|
| **Utility Parent Companies**<br>Median IDR: BBB<br>**Credit Outlook**<br>Stable | • Stable cash flow from regulated utilities; declining cash flow from competitive generation business as existing hedges expire and volume is recontracted or sold at prevailing market prices.<br>• Capital investment levels for organic growth projects and environmental upgrades remain high, requiring external financing.<br>• Equity issuance needed to maintain balanced capital mix.<br>• Favorable environment for consolidation and M&A activity. |
| **Investor-Owned Electric Utilities**<br>Median IDR Integrated Electric: BBB<br>Median IDR Electric Distribution: BBB<br>**Credit Outlook**<br>Stable | • Fitch assumes electricity sales down less than 1% in 2012 (flat on a weather normalized basis); longer term, flat to +1% weather normalized.<br>• Increased mandates for energy efficiency and conservation to restrict electricity sales growth.<br>• Serial base rate cases needed to recover infrastructure investments in 2011 and longer term. State regulatory climate varies by state, and remains a key driver.<br>• Relatively low gas and power purchase costs are favorable to utilities, reducing the upward pressures on customer bills.<br>• Sustained high capital spending on infrastructure (environmental compliance, renewables mandates, transmission projects, and automated metering.)<br>• External funding needed for capex, but companies are expected to maintain liquidity and good access to capital markets. Dependent on parent companies for equity to maintain capital structures. |
| **Gas Distribution Utilities (LDCs)**<br>Median IDR: A–<br>**Credit Outlook**<br>Stable | • Expected low natural gas commodity prices contribute to stable cash flow and improve relations with consumers, politicians, and regulators.<br>• Rate decoupling or fixed/variable tariff structures help to minimize sensitivity to variations in sales volumes.<br>• Pipeline safety issues will be a focus. However, overall, capital expenditures will remain manageable.<br>• Low risk growth potential from optionality of natural gas in new uses (transportation) as well as continued gains from fuel switching.<br>• Expect consistent regulatory treatment and manageable external funding. |
| **Competitive Generation Companies**<br>**Generating Companies and Energy Trading**<br>Median IDR: BB<br>**Credit Outlook**<br>Negative | • Flat electricity sales in 2012 and beyond with excess power capacity relative to required reserve margins to remain for several years; balance achieved through expected closings of older coal-fired units.<br>• Low gas and power price environment will depress margins for most generators; as existing hedge contracts expire, revenues per unit will reflect the weak market environment.<br>• New environmental regulations for air and water emissions will affect the outlook for coal-fired power generation and accelerate retirements of older, smaller, and less efficient coal plants.<br>• The challenges to competitive generators listed above are likely to stimulate an active M&A environment, divestitures, and consolidation.<br>• Higher power prices necessary to support investment in new build generation or environmental upgrades to uncontrolled coal plants. |

IDR – Issuer default rating. M&A – Mergers and acquisitions.
Source: Fitch Ratings.



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## Utility Parent Companies: Stable

### Key Issues

UPCs reflect the underlying business conditions of their regulated and nonregulated subsidiaries. Risks specific to UPCs include discretionary decisions such as consolidation and M&A activities, treasury share repurchases, dividend policy, and financial-management policies, as well as external factors including capital markets access, cost of capital, and inflationary cost pressure. Fitch expects UPC operating conditions in 2012 to mirror 2011, although there is greater event risk due to market disruption and contagion from the banking sector, commodities volatility, and the ongoing Eurozone crisis.

### Tax Policies

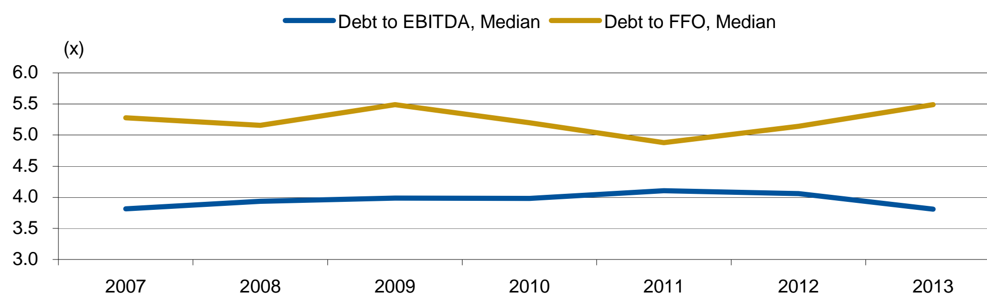
The preferential U.S. tax treatment of dividends and capital gains in effect since 2003, if not extended, would be considered a negative development for UPCs. Lower dividend taxes help utilities attract capital, which is important given their high-capital intensity. If favorable tax treatment of dividends is extended, it aids utilities and infrastructure companies that pay dividends to fund their investments at a favorable overall cost of capital. Fitch assumes the dividend tax preference continues.

Compared to other industries, U.S. utilities have a relatively high common dividend payout to net earnings ratio of approximately 60%–70%, but this is consistent with prior sector norms. Fitch anticipates modest increases in common dividends, but payout levels will likely remain within targeted levels of 60%–70%. Fitch views dividends as part of the overall corporate capital-maintenance and capital-raising objectives. Companies with regular dividend increases are more highly valued by equity investors and are at an advantage when they need to raise equity capital.

### UPC Forecast Financial Trends

Given a generally benign economic outlook in 2012, Fitch's base forecasts, on a company consolidated basis, are for aggregate earnings to improve in 2012, while key credit metrics show a mixed picture. EBITDA growth in 2012 reflects the completion and maturation of investments over the preceding years. However, FFO declines with the phase-out of bonus depreciation beginning in 2012 and absence of bonus depreciation in 2013, along with the expiration of production tax credits and other incentives that bolstered 2009 and 2010 results. Consequently, Fitch does not have specific concerns as to the decline in FFO, since it only reflects a return to normalized recurring levels.

**Leverage Ratios**




Source: Fitch Ratings.



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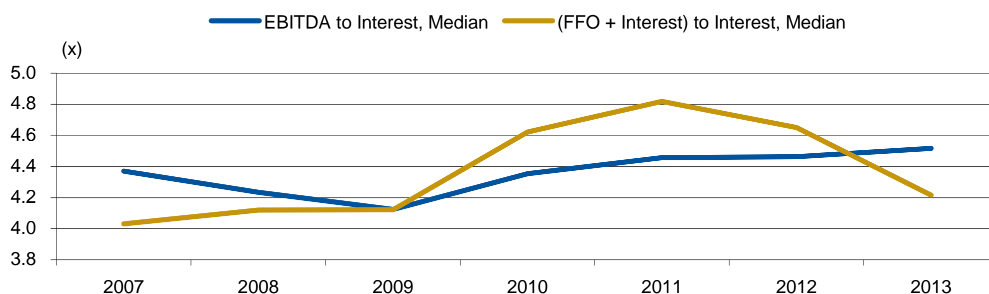
Debt leverage reflects similar divergence as coverage measures. Debt to EBITDA improves, reflecting the higher EBITDA Fitch envisions for the sector, while debt to FFO increases, reflecting the lower FFO levels Fitch expects in the absence of new tax incentives. However, in both cases the baseline returns to the 2007 period, reflecting a return to the norm.

Economic stimulus by Washington in the form of extensions of bonus depreciation and tax credits would provide upside to Fitch's FFO projections. Higher debt levels reflect funding for capex projects within a typical 50% debt/50% equity capital structure. Interest coverage measures in 2012 reflect the divergence in aggregate EBITDA and FFO measures. Over the next two years, EBITDA-to-interest measures remain relatively flat at around 4.0x coverage. At the same time, FFO to interest declines, particularly in 2013, and returns to the baseline of 2007.

**Interest Coverage Ratios**




Source: Fitch Ratings.

## Electric Utilities: Stable

Fitch's Outlook for the electric utility sector in 2012 remains stable. The sector benefits from low interest rates, modest inflationary pressures, open capital markets, and low natural gas and power prices. Fitch expects these conditions to persist into 2013.

The favorable funding environment helps to offset any stress that would otherwise result during an extended period of high projected capital investment. Capex is expected to remain elevated, increasing 5%–6% over 2011 levels.

Many utilities have reduced regulatory risk by shifting cost recovery from general rate case proceedings to standardized tariffs that provide greater certainty and timeliness of cost recovery. Moreover, utility investment in this construction cycle seems to be aligned with the goals of regulators and policymakers, enhancing prospects for timely and full investment recovery, in Fitch's opinion.

Fitch's outlook for the sector presumes an extended period of cyclically low power and natural gas prices. Electric utilities, particularly T&D utilities, are beneficiaries of low commodity prices. Low prices for fuel commodities provide crucial headroom for utilities to recover anticipated investment in plant and equipment through base rate increases. All else equal, stable to lower natural gas and power prices remove a source of upward pressure on monthly utility bills, and reduce potential consumer resistance/political backlash to higher rates. Similarly, a low inflation and interest rate environment would stabilize utilities' costs and rates.



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Longer term, risks to the Stable Outlook become more pronounced as secular and cyclical factors come into play. Sales growth expectations, already modest at 1%–2% per annum, may prove optimistic given the subdued economic growth outlook and a growing demand for energy efficiency and conservation. The industry faces the double threat of both disruptive technologies, such as efficiencies in lighting, refrigeration, and software interface, combined with competitors promoting such products and services. The industry will be challenged to adjust business models to face the new competitive landscape.

A more immediate threat might be a change in the operating environment in 2013 and beyond. Fitch has specific concerns regarding upward pressure on electricity rates owing to reliance on higher cost, non-emitting renewable and other energy resources, and potentially higher interest rates, inflation, natural gas, and power costs from the current cyclically low levels. The upward pressure on electricity rates in this scenario could lead to political resistance to future rate increase requests and the potential inability to fully recover prior costs and investments, resulting in credit rating downgrades.

### State Tariff Regulation

A 2011 Fitch survey of authorized ROEs reflects a continued trend of lower ROEs. Authorized ROEs are now trending down to the 10% level from a range of 10.25% to 10.50% registered at Fitch's last survey in 2009. The trend is not surprising given the overall low interest rate environment and cost of capital benchmarks for alternative investments. Lower ROEs are also associated with features increasingly common in tariff structures that minimize cash flow volatility. Still, the trend will pressure earnings and key coverage and leverage credit measures, including EBITDA to interest and debt to EBITDA.

There has been a notable increase in recent years in the utilization of fuel-adjustment clauses, pre-approval of major construction projects, environmental riders, the use of CWIP in rate base, and other tariff mechanisms designed to move cost recovery out of general rate case proceedings and/or provide greater assurance of cost recovery. Such mechanisms reduce earnings attrition and business risk, and are viewed favorably in Fitch's credit rating decisions.

The electricity industry, particularly in the northeast, suffered a number of storms that resulted in substantial damage to the system infrastructure and long periods of customer outages. Typically, such expenses and capital costs are recoverable, frequently through a tariff monetization financing. However, in cases where the regulators feel the utility did not respond properly, a portion of such expenses would likely be absorbed by the utility. Fourth-quarter 2011 results may reflect such items.

## Gas Utilities: Stable

Fitch's 2012 Outlook for LDCs remains Stable. Gas utilities are advantaged by low natural gas prices, which minimize customer conservation, and long-term forecasts of abundant and low-priced natural gas supplies, which stimulate conversions to natural gas from other fuel sources. While the slow pace of economic recovery has limited sales growth, LDCs remain well positioned with modest capex requirements, mostly related to system reliability and maintenance.

Natural gas prices are expected to remain at low levels in the wake of abundant domestic supplies. Entering the 2011–2012 winter heating season, storage levels remain robust and should allow all-in rates to consumers to remain manageable. While many LDCs either have or are pursuing some form of rate decoupling or weather normalization that shields financial



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results from the effects of changes in volumes sold, low gas prices are nevertheless positive as lower overall rates alleviate concerns related to bad debt expense and regulatory pressures. The lower cost of gas inventories in storage and carrying customer receivables during the peak winter season have also had a meaningful effect on reduced liquidity needs for many LDCs.

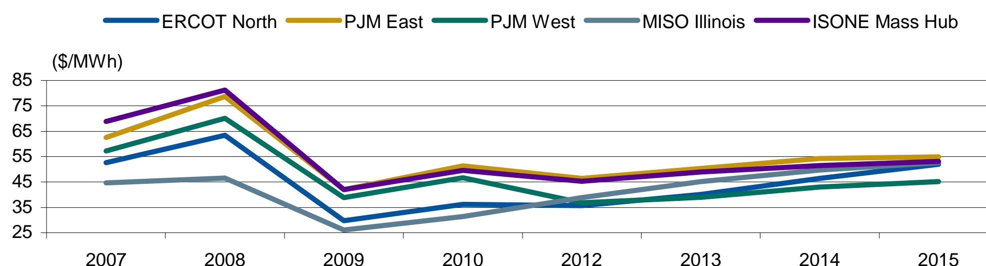
Weather, especially for gas utilities without decoupling mechanisms, is the biggest variable in financial performance.

Limited concerns will be centered on the increased focus on pipeline and system safety following several high-profile accidents. Fitch believes the enhanced inspection and testing programs being enacted across the industry will largely be recoverable in future rate cases.

## Competitive Generators: Negative

Fitch expects the competitive gencos to continue to face a challenging operating environment in 2012. Some gencos are affiliated merchant generators, which are subsidiaries of large utility holding companies, while others are stand-alone IPPs. Both types of companies are adversely affected by a depressed commodity environment, expiring above-market hedges, and more stringent environmental regulations that could adversely affect uncontrolled coal-fired generation. However, unlike IPPs, affiliated gencos tend to benefit from strong parent or affiliate linkages and better access to capital during periods of volatile capital market conditions.

**Historical and Forecast Round-the-Clock Power Prices**
(As of Oct. 10, 2011)




ERCOT – Electric Reliability Council of Texas. ISONE – ISO New England. MISO – Midwest ISO.
Source: Wood MacKenzie.

Fitch expects aggregate credit metrics for gencos to weaken in 2012. This primarily reflects the effect of lower power prices as older, higher priced contracts expire and get remarketed in a weaker commodity environment. Implementation of CSAPR will also impinge on profitability and cash flows at several coal-fired plants due to curtailment of production and higher costs from fuel switching and blending. Fitch considers it quite likely that such conditions persist well into 2013, until demand supply becomes more balanced in various regional power markets, leading to a stronger recovery in power prices.

Liquidity remains a key rating consideration for high-yield gencos. Fitch believes liquidity is adequate for 2012. However, rising capital requirements at coal-fired generators will deplete excess cash balances. For the gencos with natural gas assets and/or a more diversified portfolio, excess cash could likely be diverted toward stock purchases, investment in new generation (natural gas-fired/renewables), or vertical integration into the retail business. Fitch



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will continue to evaluate these actions in the context of overall management strategy and credit metrics.

AES, NRG Energy Co., and Calpine have each announced their intention to return capital to shareholders. Rating pressures could appear if there is an outsized return of capital to shareholders. Fitch believes capital market conditions for high-yield issuers have not normalized, and any disruptions due to macroeconomic events could periodically shut market access for them.

Aside from credit metrics, individual issuer rating and outlook are also influenced to a large extent by fuel mix, location, age, and extent of environmental compliance of its power-generation assets. Fitch believes emission-free generators are likely to be beneficiaries of stringent environmental regulations as old and inefficient coal plants retire, thereby rendering the demand supply balance more favorable to supporting higher power prices. Among the various regional markets, Fitch believes ERCOT is particularly attractive, as evidenced by the squeeze in reserve margin during the 2011 summer heat wave. This should aid the gencos that have a significant exposure to ERCOT.



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