Criteria | Corporates | Utilities:

Key Credit Factors For The Regulated Utilities Industry

November 19, 2013

(***Editor's Note:*** *On April 5, 2021, we republished this criteria article to make nonmaterial changes. See the "Revisions And Updates" section for details.)*

1. This article presents S&P Global Ratings' methodology and assumptions for Regulated Utilities. This article relates to "Corporate Methodology" and "Principles Of Credit Ratings."
2. This paragraph has been deleted.

SCOPE OF THE CRITERIA

3. These criteria apply to entities where regulated utilities represent a material part of their business, other than U.S. public power, water, sewer, gas, and electric cooperative utilities that are owned by federal, state, or local governmental bodies or by ratepayers. A regulated utility is defined as a corporation that offers an essential or near-essential infrastructure product, commodity, or service with little or no practical substitute (mainly electricity, water, and gas), a business model that is shielded from competition (naturally, by law, shadow regulation, or by government policies and oversight), and is subject to comprehensive regulation by a regulatory body or implicit oversight of its rates (sometimes referred to as tariffs), service quality, and terms of service. The regulators base the rates that they set on some form of cost recovery, including an economic return on assets, rather than relying on a market price. The regulated operations can range from individual parts of the utility value chain (water, gas, and electricity networks or "grids," electricity generation, retail operations, etc.) to the entire integrated chain, from procurement to sales to the end customer. In some jurisdictions, our view of government support can also affect the final rating outcome, as per our government-related entity criteria (see "General Criteria: Rating Government-Related Entities: Methodology and Assumptions").

SUMMARY OF THE CRITERIA

4. This article presents S&P Global Ratings criteria for analyzing regulated utilities, applying its corporate criteria. The criteria for evaluating the competitive position of regulated utilities amend and partially supersede the "Competitive Position" section of the corporate criteria when evaluating these entities. The criteria for determining the cash flow leverage assessment partially supersede the "Cash Flow/Leverage" section of the corporate criteria for the purpose of evaluating regulated utilities, specifically, the conditions to apply low, medial, and standard volatility tables. The section on liquidity for regulated utilities partially amends existing criteria. All

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other sections of the corporate criteria apply to the analysis of regulated utilities.

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METHODOLOGY

Part I--Business Risk Analysis

Industry risk

7. The industry risk is assessed by applying S&P Global Ratings' criteria for assessing industry risk (see "Methodology: Industry Risk"). For the most recent assessments for the regulated utilities industry, see "Industry Risk Assessments Update," which is updated from time to time.
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B. Country risk

16. In assessing "country risk" for a regulated utility, our analysis uses the same methodology as with other corporate issuers (see "Corporate Methodology").

C. Competitive position

17. In the corporate criteria, competitive position is assessed as ('1') excellent, ('2') strong, ('3') satisfactory, ('4') fair, ('5') weak, or ('6') vulnerable.
18. The analysis of competitive position includes a review of:
    - Competitive advantage,
    - Scale, scope, and diversity,
    - Operating efficiency, and
    - Profitability.
19. In the corporate criteria we assess the strength of each of the first three components. Each component is assessed as either: (1) strong, (2) strong/adequate, (3) adequate, (4) adequate/weak, or (5) weak. After assessing these components, we determine the preliminary competitive position assessment by ascribing a specific weight to each component. The applicable weightings will depend on the company's Competitive Position Group Profile. The group profile for

regulated utilities is "National Industries & Utilities," with a weighting of the three components as follows: competitive advantage (60%), scale, scope, and diversity (20%), and operating efficiency (20%). Profitability is assessed by combining two sub-components: level of profitability and the volatility of profitability.

20. "Competitive advantage" cannot be measured with the same sub-factors as competitive firms because utilities are not primarily subject to influence of market forces. Therefore, these criteria supersede the "competitive advantage" section of the corporate criteria. We analyze instead a utility's "regulatory advantage" (section 1 below).

Assessing regulatory advantage

21. The regulatory framework/regime's influence is of critical importance when assessing regulated utilities' credit risk because it defines the environment in which a utility operates and has a significant bearing on a utility's financial performance.

22. We base our assessment of the regulatory framework's relative credit supportiveness on our view of how regulatory stability, efficiency of tariff setting procedures, financial stability, and regulatory independence protect a utility's credit quality and its ability to recover its costs and earn a timely return. Our view of these four pillars is the foundation of a utility's regulatory support. We then assess the utility's business strategy, in particular its regulatory strategy and its ability to manage the tariff-setting process, to arrive at a final regulatory advantage assessment.

23. When assessing regulatory advantage, we first consider four pillars and sub-factors that we believe are key for a utility to recover all its costs, on time and in full, and earn a return on its capital employed:

24. Regulatory stability:
    - Transparency of the key components of the rate setting and how these are assessed
    - Predictability that lowers uncertainty for the utility and its stakeholders
    - Consistency in the regulatory framework over time

25. Tariff-setting procedures and design:
    - Recoverability of all operating and capital costs in full
    - Balance of the interests and concerns of all stakeholders affected
    - Incentives that are achievable and contained

26. Financial stability:
    - Timeliness of cost recovery to avoid cash flow volatility
    - Flexibility to allow for recovery of unexpected costs if they arise
    - Attractiveness of the framework to attract long-term capital
    - Capital support during construction to alleviate funding and cash flow pressure during periods of heavy investments

27. Regulatory independence and insulation:
    - Market framework and energy policies that support long-term financial stability of the utilities and that is clearly enshrined in law and separates the regulator's powers
    - Risks of political intervention is absent so that the regulator can efficiently protect the utility's

credit profile even during a stressful event

28. We have summarized the key characteristics of the assessments for regulatory advantage in table 1.

Table 1

Preliminary Regulatory Advantage Assessment

Qualifier	What it means	Guidance
Strong	The utility has a major regulatory advantage due to one or a combination of factors that support cost recovery and a return on capital combined with lower than average volatility of earnings and cash flows.	The utility operates in a regulatory climate that is transparent, predictable, and consistent from a credit perspective.
	There are strong prospects that the utility can sustain this advantage over the long term.	The utility can fully and timely recover all its fixed and variable operating costs, investments and capital costs (depreciation and a reasonable return on the asset base).
	This should enable the utility to withstand economic downturns and political risks better than other utilities.	The tariff set may include a pass-through mechanism for major expenses such as commodity costs, or a higher return on new assets, effectively shielding the utility from volume and input cost risks.
		Any incentives in the regulatory scheme are contained and symmetrical.
		The tariff set includes mechanisms allowing for a tariff adjustment for the timely recovery of volatile or unexpected operating and capital costs.
		There is a track record of earning a stable, compensatory rate of return in cash through various economic and political cycles and a projected ability to maintain that record.
		There is support of cash flows during construction of large projects, and pre-approval of capital investment programs and large projects lowers the risk of subsequent disallowances of capital costs.
		The utility operates under a regulatory system that is sufficiently insulated from political intervention to efficiently protect the utility's credit risk profile even during stressful events.
Adequate	The utility has some regulatory advantages and protection, but not to the extent that it leads to a superior business model or durable benefit.	It operates in a regulatory environment that is less transparent, less predictable, and less consistent from a credit perspective.
	The utility has some but not all drivers of well-managed regulatory risk. Certain regulatory factors support the business's long-term stability and viability but could result in periods of below-average levels of profitability and greater profit volatility. However, overall these regulatory drivers are partially offset by the utility's disadvantages or lack of sustainability of other factors.	The utility is exposed to delays or is not, with sufficient certainty, able to recover all of its fixed and variable operating costs, investments. and capital costs (depreciation and a reasonable return on the asset base) within a reasonable time.
		Incentive ratemaking practices are asymmetrical and material, and could detract from credit quality.

Table 1

Preliminary Regulatory Advantage Assessment (cont.)

Qualifier	What it means	Guidance
		The utility is exposed to the risk that it doesn't recover unexpected or volatile costs in a full or less than timely manner due to lack of flexible reopeners or annual revenue adjustments.
		There is an uneven track record of earning a compensatory rate of return in cash through various economic and political cycles and a projected ability to maintain that record.
		There is little or no support of cash flows during construction, and investment decisions on large projects (and therefore the risk of subsequent disallowances of capital costs) rest mostly with the utility.
		The utility operates under a regulatory system that is not sufficiently insulated from political intervention and is sometimes subject to overt political influence.
Weak	The utility suffers from a complete breakdown of regulatory protection that places the utility at a significant disadvantage.	The utility operates in an opaque regulatory climate that lacks transparency, predictability, and consistency.
	The utility's regulatory risk is such that the long-term cost recovery and investment return is highly uncertain and materially delayed, leading to volatile or weak cash flows. There is the potential for material stranded assets with no prospect of recovery.	The utility cannot fully and/or timely recover its fixed and variable operating costs, investments, and capital costs (depreciation and a reasonable return on the asset base).
		There is a track record of earning minimal or negative rates of return in cash through various economic and political cycles and a projected inability to improve that record sustainably.
		The utility must make significant capital commitments with no solid legal basis for the full recovery of capital costs.
		Ratemaking practices actively harm credit quality.
		The utility is regularly subject to overt political influence.

29. After determining the preliminary regulatory advantage assessment, we then assess the utility's business strategy. Most importantly, this factor addresses the effectiveness of a utility's management of the regulatory risk in the jurisdiction(s) where it operates. In certain jurisdictions, a utility's regulatory strategy and its ability to manage the tariff-setting process effectively so that revenues change with costs can be a compelling regulatory risk factor. A utility's approach and strategies surrounding regulatory matters can create a durable "competitive advantage" that differentiates it from peers, especially if the risk of political intervention is high. The assessment of a utility's business strategy is informed by historical performance and its forward-looking business objectives. We evaluate these objectives in the context of industry dynamics and the regulatory climate in which the utility operates, as evaluated through the factors cited in paragraphs 24-27.

30. We modify the preliminary regulatory advantage assessment to reflect this influence positively or negatively. Where business strategy has limited effect relative to peers, we view the implications as neutral and make no adjustment. A positive assessment improves the preliminary regulatory advantage assessment by one category and indicates that management's business strategy is expected to bolster its regulatory advantage through favorable commission rulings beyond what is typical for a utility in that jurisdiction. Conversely, where management's strategy or businesses decisions result in adverse regulatory outcomes relative to peers, such as failure to achieve typical cost recovery or allowed returns, we adjust the preliminary regulatory advantage assessment one category worse. In extreme cases of poor strategic execution, the preliminary regulatory advantage assessment is adjusted by two categories worse (when possible; see table 2) to reflect management decisions that are likely to result in a significantly adverse regulatory outcome relative to peers.

Table 2

Determining The Final Regulatory Advantage Assessment

	--Strategy modifier--			
Preliminary regulatory advantage score	**Positive**	**Neutral**	**Negative**	**Very negative**
Strong	Strong	Strong	Strong/Adequate	Adequate
Strong/Adequate	Strong	Strong/Adequate	Adequate	Adequate/Weak
Adequate	Strong/Adequate	Adequate	Adequate/Weak	Weak
Adequate/Weak	Adequate	Adequate/Weak	Weak	Weak
Weak	Adequate/Weak	Weak	Weak	Weak

Scale, scope, and diversity

31. We consider the key factors for this component of competitive position to be primarily operational scale and diversity of the geographic, economic, and regulatory foot prints. We focus on a utility's markets, service territories, and diversity and the extent that these attributes can contribute to cash flow stability while dampening the effect of economic and market threats.

32. A utility that warrants a Strong or Strong/Adequate assessment has scale, scope, and diversity that support the stability of its revenues and profits by limiting its vulnerability to most combinations of adverse factors, events, or trends. The utility's significant advantages enable it to withstand economic, regional, competitive, and technological threats better than its peers. It typically is characterized by a combination of the following factors:

- A large and diverse customer base with no meaningful customer concentration risk, where residential and small to medium commercial customers typically provide most operating income.
- The utility's range of service territories and regulatory jurisdictions is better than others in the sector.
- Exposure to multiple regulatory authorities where we assess preliminary regulatory advantage to be at least Adequate. In the case of exposure to a single regulatory regime, the regulatory advantage assessment is either Strong or Strong/Adequate.
- No meaningful exposure to a single or few assets or suppliers that could hurt operations or could not easily be replaced.

33. A utility that warrants a Weak or Weak/Adequate assessment lacks scale, scope, and diversity such that it compromises the stability and sustainability of its revenues and profits. The utility's vulnerability to, or reliance on, various elements of this sub-factor is such that it is less likely than its peers to withstand economic, competitive, or technological threats. It typically is characterized by a combination of the following factors:

- A small customer base, especially if burdened by customer and/or industry concentration combined with little economic diversity and average to below-average economic prospects;
- Exposure to a single service territory and a regulatory authority with a preliminary regulatory advantage assessment of Adequate or Adequate/Weak; or
- Dependence on a single supplier or asset that cannot easily be replaced and which hurts the utility's operations.

34. We generally believe a larger service territory with a diverse customer base and average to above-average economic growth prospects provides a utility with cushion and flexibility in the recovery of operating costs and ongoing investment (including replacement and growth capital spending), as well as lessening the effect of external shocks (i.e., extreme local weather) since the incremental effect on each customer declines as the scale increases.

35. We consider residential and small commercial customers as having more stable usage patterns and being less exposed to periodic economic weakness, even after accounting for some weather-driven usage variability. Significant industrial exposure along with a local economy that largely depends on one or few cyclical industries potentially contributes to the cyclicality of a utility's load and financial performance, magnifying the effect of an economic downturn.

36. A utility's cash flow generation and stability can benefit from operating in multiple geographic regions that exhibit average to better than average levels of wealth, employment, and growth that underpin the local economy and support long-term growth. Where operations are in a single geographic region, the risk can be ameliorated if the region is sufficiently large, demonstrates economic diversity, and has at least average demographic characteristics.

37. The detriment of operating in a single large geographic area is subject to the strength of regulatory assessment. Where a utility operates in a single large geographic area and has a strong regulatory assessment, the benefit of diversity can be incremental.

Operating efficiency

38. We consider the key factors for this component of competitive position to be:

- Compliance with the terms of its operating license, including safety, reliability, and environmental standards;
- Cost management; and
- Capital spending: scale, scope, and management.

39. Relative to peers, we analyze how successful a utility management achieves the above factors within the levels allowed by the regulator in a manner that promotes cash flow stability. We consider how management of these factors reduces the prospect of penalties for noncompliance, operating costs being greater than allowed, and capital projects running over budget and time, which could hurt full cost recovery.

40. The relative importance of the above three factors, particularly cost and capital spending management, is determined by the type of regulation under which the utility operates. Utilities

operating under robust "cost plus" regimes tend to be more insulated given the high degree of confidence costs will invariably be passed through to customers. Utilities operating under incentive-based regimes are likely to be more sensitive to achieving regulatory standards. This is particularly so in the regulatory regimes that involve active consultation between regulator and utility and market testing as opposed to just handing down an outcome on a more arbitrary basis.

41. In some jurisdictions, the absolute performance standards are less relevant than how the utility performs against the regulator's performance benchmarks. It is this performance that will drive any penalties or incentive payments and can be a determinant of the utilities' credibility on operating and asset-management plans with its regulator.

42. Therefore, we consider that utilities that perform these functions well are more likely to consistently achieve determinations that maximize the likelihood of cost recovery and full inclusion of capital spending in their asset bases. Where regulatory resets are more at the discretion of the utility, effective cost management, including of labor, may allow for more control over the timing and magnitude of rate filings to maximize the chances of a constructive outcome such as full operational and capital cost recovery while protecting against reputational risks.

43. A regulated utility that warrants a Strong or Strong/Adequate assessment for operating efficiency relative to peers generates revenues and profits through minimizing costs, increasing efficiencies, and asset utilization. It typically is characterized by a combination of the following:

- High safety record;
- Service reliability is strong, with a track record of meeting operating performance requirements of stakeholders, including those of regulators. Moreover, the utility's asset profile (including age and technology) is such that we have confidence that it could sustain favorable performance against targets;
- Where applicable, the utility is well-placed to meet current and potential future environmental standards;
- Management maintains very good cost control. Utilities with the highest assessment for operating efficiency have shown an ability to manage both their fixed and variable costs in line with regulatory expectations (including labor and working capital management being in line with regulator's allowed collection cycles); or
- There is a history of a high level of project management execution in capital spending programs, including large one-time projects, almost invariably within regulatory allowances for timing and budget.

44. A regulated utility that warrants an Adequate assessment for operating efficiency relative to peers has a combination of cost position and efficiency factors that support profit sustainability combined with average volatility. Its cost structure is similar to its peers. It typically is characterized by a combination of the following factors:

- High safety performance;
- Service reliability is satisfactory with a track record of mostly meeting operating performance requirements of stakeholders, including those of regulators. We have confidence that a favorable performance against targets can be mostly sustained;
- Where applicable, the utility may be challenged to comply with current and future environmental standards that could increase in the medium term;
- Management maintains adequate cost control. Utilities that we assess as having adequate operating efficiency mostly manage their fixed and variable costs in line with regulatory

expectations (including labor and working capital management being mostly in line with regulator's allowed collection cycles); or

- There is a history of adequate project management skills in capital spending programs within regulatory allowances for timing and budget.

45. A regulated utility that warrants a weak or weak/adequate assessment for operating efficiency relative to peers has a combination of cost position and efficiency factors that fail to support profit sustainability combined with below-average volatility. Its cost structure is worse than its peers. It typically is characterized by a combination of the following:

- Poor safety performance;
- Service reliability has been sporadic or non-existent with a track record of not meeting operating performance requirements of stakeholders, including those of regulators. We do not believe the utility can consistently meet performance targets without additional capital spending;
- Where applicable, the utility is challenged to comply with current environmental standards and is highly vulnerable to more onerous standards;
- Management typically exceeds operating costs authorized by regulators;
- Inconsistent project management skills as evidenced by cost overruns and delays including for maintenance capital spending; or
- The capital spending program is large and complex and falls into the weak or weak/adequate assessment, even if operating efficiency is generally otherwise considered adequate.

Profitability

46. A utility with above-average profitability would, relative to its peers, generally earn a rate of return at or above what regulators authorize and have minimal exposure to earnings volatility from affiliated unregulated business activities or market-sensitive regulated operations. Conversely, a utility with below-average profitability would generally earn rates of return well below the authorized return relative to its peers or have significant exposure to earnings volatility from affiliated unregulated business activities or market-sensitive regulated operations.

47. The profitability assessment consists of "level of profitability" and "volatility of profitability."

Level of profitability

48. Key measures of general profitability for regulated utilities commonly include ratios, which we compare both with those of peers and those of companies in other industries to reflect different countries' regulatory frameworks and business environments:

- EBITDA margin,
- Return on capital (ROC), and
- Return on equity (ROE).

49. In many cases, EBITDA as a percentage of sales (i.e., EBITDA margin) is a key indicator of profitability. This is because the book value of capital does not always reflect true earning potential, for example when governments privatize or restructure incumbent state-owned utilities. Regulatory capital values can vary with those of reported capital because regulatory capital values

are not inflation-indexed and could be subject to different assumptions concerning depreciation. In general, a country's inflation rate or required rate of return on equity investment is closely linked to a utility company's profitability. We do not adjust our analysis for these factors, because we can make our assessment through a peer comparison.

50. For regulated utilities subject to full cost-of-service regulation and return-on-investment requirements, we normally measure profitability using ROE, the ratio of net income available for common stockholders to average common equity. When setting rates, the regulator ultimately bases its decision on an authorized ROE. However, different factors such as variances in costs and usage may influence the return a utility is actually able to earn, and consequently our analysis of profitability for cost-of-service-based utilities centers on the utility's ability to consistently earn the authorized ROE.

51. We will use return on capital when pass-through costs distort profit margins--for instance congestion revenues or collection of third-party revenues. This is also the case when the utility uses accelerated depreciation of assets, which in our view might not be sustainable in the long run.

Volatility of profitability

52. We may observe a clear difference between the volatility of actual profitability and the volatility of underlying regulatory profitability. In these cases, we could use the regulatory accounts as a proxy to judge the stability of earnings.

53. We use actual returns to calculate the standard error of regression for regulated utility issuers (only if there are at least seven years of historical annual data to ensure meaningful results). If we believe recurring mergers and acquisitions or currency fluctuations affect the results, we may make adjustments.

Part II--Financial Risk Analysis

D. Accounting

54. Our analysis of a company's financial statements begins with a review of the accounting to determine whether the statements accurately measure a company's performance and position relative to its peers and the larger universe of corporate entities. To allow for globally consistent and comparable financial analyses, our rating analysis may include quantitative adjustments to a company's reported results. These adjustments also align a company's reported figures with our view of underlying economic conditions and give us a more accurate portrayal of a company's ongoing business. We discuss adjustments that pertain broadly to all corporate sectors, including this sector, in "Corporate Methodology: Ratios And Adjustments." Accounting characteristics unique to this sector are discussed below.

Accounting characteristics

55. Some important accounting practices for utilities include:

- For integrated electric utilities that meet native load obligations in part with third-party power contracts, we use our purchased power methodology to adjust measures for the debt-like obligation such contracts represent.

- Due to distortions in leverage measures from the substantial seasonal working-capital requirements of natural gas distribution utilities, we adjust inventory and debt balances by netting the value of inventory against outstanding short-term borrowings. This adjustment provides an accurate view of the company's balance sheet by reducing seasonal debt balances when we see a very high certainty of near-term cost recovery.
- We deconsolidate securitized debt (and associated revenues and expenses) that has been accorded specialized recovery provisions.

56. In the U.S. and selectively in other regions, utilities employ "regulatory accounting," which permits a rate-regulated company to defer some revenues and expenses to match the timing of the recognition of those items in rates as determined by regulators. A utility subject to regulatory accounting will therefore have assets and liabilities on its books that an unregulated corporation, or even regulated utilities in many other global regions, cannot record. We do not adjust GAAP earnings or balance-sheet figures to remove the effects of regulatory accounting. However, as more countries adopt International Financial Reporting Standards (IFRS), the use of regulatory accounting will become more scarce. IFRS does not currently provide for any recognition of the effects of rate regulation for financial reporting purposes, but it is considering the use of regulatory accounting. We do not anticipate altering our fundamental financial analysis of utilities because of the use or non-use of regulatory accounting. We will continue to analyze the effects of regulatory actions on a utility's financial health.

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E. Cash flow/leverage analysis

75. In assessing the cash flow adequacy of a regulated utility, our analysis uses the same methodology as with other corporate issuers (see "Corporate Methodology"). We assess cash

flow/leverage on a six-point scale ranging from ('1') minimal to ('6') highly leveraged. These scores are determined by aggregating the assessments of a range of credit ratios, predominantly cash flow-based, which complement each other by focusing attention on the different levels of a company's cash flow waterfall in relation to its obligations.

76. The corporate methodology provides benchmark ranges for various cash flow ratios we associate with different cash flow leverage assessments for standard volatility, medial volatility, and low volatility industries. The tables of benchmark ratios differ for a given ratio and cash flow leverage assessment along two dimensions: the starting point for the ratio range and the width of the ratio range.

77. If an industry's volatility levels are low, the threshold levels for the applicable ratios to achieve a given cash flow leverage assessment are less stringent, although the width of the ratio range is narrower. Conversely, if an industry has standard levels of volatility, the threshold levels for the applicable ratios to achieve a given cash flow leverage assessment may be elevated, but with a wider range of values.

78. We apply the "low-volatility" table to regulated utilities that qualify under the corporate criteria and with all of the following characteristics:

- A vast majority of operating cash flows come from regulated operations that are predominantly at the low end of the utility risk spectrum (e.g., a "network," or distribution/transmission business unexposed to commodity risk and with very low operating risk);
- A "strong" regulatory advantage assessment;
- An established track record of normally stable credit measures that is expected to continue;
- A demonstrated long-term track record of low funding costs (credit spread) for long-term debt that is expected to continue; and
- Non-utility activities that are in a separate part of the group (as defined in our group rating methodology) that we consider to have "nonstrategic" group status and are not deemed high risk and/or volatile.

79. We apply the "medial volatility" table to companies that do not qualify under paragraph 78 with:

- A majority of operating cash flows from regulated activities with an "adequate" or better regulatory advantage assessment; or
- About one-third or more of consolidated operating cash flow comes from regulated utility activities with a "strong" regulatory advantage and where the average of its remaining activities have a competitive position assessment of '3' or better.

80. We apply the "standard-volatility" table to companies that do not qualify under paragraph 79 and with either:

- About one-third or less of its operating cash flow comes from regulated utility activities, regardless of its regulatory advantage assessment; or
- A regulatory advantage assessment of "adequate/weak" or "weak."

Part III--Rating Modifiers

F. Diversification/portfolio effect

81. In assessing the diversification/portfolio effect on a regulated utility, our analysis uses the same methodology as with other corporate issuers (see "Corporate Methodology").

G. Capital structure

82. In assessing the quality of the capital structure of a regulated utility, we use the same methodology as with other corporate issuers (see "Corporate Methodology").

H. Liquidity

83. In assessing a utility's liquidity/short-term factors, our analysis is consistent with the methodology that applies to corporate issuers (see "Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers").

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I. Financial policy

85. In assessing financial policy on a regulated utility, our analysis uses the same methodology as with other corporate issuers (see "Corporate Methodology").

J. Management and governance

86. In assessing management and governance on a regulated utility, our analysis uses the same methodology as with other corporate issuers (see "Corporate Methodology").

K. Comparable ratings analysis

87. In assessing the comparable ratings analysis on a regulated utility, our analysis uses the same methodology as with other corporate issuers (see "Corporate Methodology").

APPENDIX--Frequently Asked Questions

Does S&P Global Ratings expect that the business strategy modifier to the preliminary regulatory advantage will be used extensively?

88. Globally, we expect management's influence will be neutral in most jurisdictions. Where the regulatory assessment is "strong," it is less likely that a negative business strategy modifier would be used due to the nature of the regulatory regime that led to the "strong" assessment in the first place. Utilities in "adequate/weak" and "weak" regulatory regimes are challenged to outperform due to the uncertainty of such regulatory regimes. For a positive use of the business strategy modifier, there would need to be a track record of the utility consistently outperforming the parameters laid down under a regulatory regime, and we would need to believe this could be sustained. The business strategy modifier is most likely to be used when the preliminary regulatory advantage assessment is "strong/adequate" because the starting point in the

assessment is reasonably supportive, and a utility has shown it manages regulatory risk better or worse than its peers in that regulatory environment and we expect that advantage or disadvantage will persist. An example would be a utility that can consistently earn or exceed its authorized return in a jurisdiction where most other utilities struggle to do so. If a utility is treated differently by a regulator due to perceptions of poor customer service or reliability and the "operating efficiency" component of the competitive position assessment does not fully capture the effect on the business risk profile, a negative business strategy modifier could be used to accurately incorporate it into our analysis. We expect very few utilities will be assigned a "very negative" business strategy modifier.

Does a relatively strong or poor relationship between the utility and its regulator compared with its peers in the same jurisdiction necessarily result in a positive or negative adjustment to the preliminary regulatory advantage assessment?

89. No. The business strategy modifier is used to differentiate a company's regulatory advantage within a jurisdiction where we believe management's business strategy has and will positively or negatively affect regulatory outcomes beyond what is typical for other utilities in that jurisdiction. For instance, in a regulatory jurisdiction where allowed returns are negotiated rather than set by formula, a utility that is consistently authorized higher returns (and is able to earn that return) could warrant a positive adjustment. A management team that cannot negotiate an approved capital spending program to improve its operating performance could be assessed negatively if its performance lags behind peers in the same regulatory jurisdiction.

What is your definition of regulatory jurisdiction?

90. A regulatory jurisdiction is defined as the area over which the regulator has oversight and could include single or multiple subsectors (water, gas, and power). A geographic region may have several regulatory jurisdictions. For example, the Office of Gas and Electricity Markets and the Water Services Regulation Authority in the U.K. are considered separate regulatory jurisdictions. In Ontario, Canada, the Ontario Energy Board represents a single jurisdiction with regulatory oversight for power and gas. Also, in Australia, the Australian Energy Regulator would be considered a single jurisdiction given that it is responsible for both electricity and gas transmission and distribution networks in the entire country, with the exception of Western Australia.

Are there examples of different preliminary regulatory advantage assessments in the same country or jurisdiction?

91. Yes. In Israel we rate a regulated integrated power utility and a regulated gas transmission system operator (TSO). The power utility's relationship with its regulator is extremely poor in our view, which led to significant cash flow volatility in a stress scenario (when terrorists blew up the gas pipeline that was then Israel's main source of natural gas, the utility was unable to negotiate compensation for expensive alternatives in its regulated tariffs). We view the gas TSO's relationship with its regulator as very supportive and stable. Because we already reflected this in very different preliminary regulatory advantage assessments, we did not modify the preliminary assessments because the two regulatory environments in Israel differ and were not the result of the companies' respective business strategies.

How is regulatory advantage assessed for utilities that are a natural monopoly but are not regulated by a regulator or a specific regulatory framework, and do you use the regulatory modifier if they achieve favorable treatment from the government as an owner?

92. The four regulatory pillars remain the same. On regulatory stability we look at the stability of the setup, with more emphasis on the historical track record and our expectations regarding future changes. In tariff-setting procedures and design we look at the utility's ability to fully recover operating costs, investments requirements, and debt-service obligations. In financial stability we look at the degree of flexibility in tariffs to counter volume risk or commodity risk. The flexibility can also relate to the level of indirect competition the utility faces. For example, while Nordic district heating companies operate under a natural monopoly, their tariff flexibility is partly restricted by customers' option to change to a different heating source if tariffs are significantly increased. Regulatory independence and insulation is mainly based on the perceived risk of political intervention to change the setup that could affect the utility's credit profile. Although political intervention tends to be mostly negative, in certain cases political ties due to state ownership might positively influence tariff determination. We believe that the four pillars effectively capture the benefits from the close relationship between the utility and the state as an owner; therefore, we do not foresee the use of the regulatory modifier.

In table 1, when describing a "strong" regulatory advantage assessment, you mention that there is support of cash flows during construction of large projects, and preapproval of capital investment programs and large projects lowers the risk of subsequent disallowances of capital costs. Would this preclude a "strong" regulatory advantage assessment in jurisdictions where those practices are absent?

93. No. The table is guidance as to what we would typically expect from a regulatory framework that we would assess as "strong." We would expect some frameworks with no capital support during construction to receive a "strong" regulatory advantage assessment if in aggregate the other factors we analyze support that conclusion.

REVISIONS AND UPDATES

This article was originally published on Nov. 19, 2013. These criteria became effective on Nov. 19, 2013.

Changes introduced after original publication:

- Following our periodic review completed on June 17, 2016, we updated the contact information and criteria references and deleted paragraphs 2, 5, and 6, which were related to the initial publication of our criteria and no longer relevant.
- Following our periodic review completed on June 6, 2017, we updated the contact information and criteria references and clarified paragraphs 4 and 84.
- Following our periodic review completed on June 5, 2018, we updated the contact information and criteria references and renamed the "Revision History" section to "Revisions And Updates."

- On April 1, 2019, we republished this criteria article to make nonmaterial changes. We deleted paragraphs 57-74 because they were superseded by "Corporate Methodology: Ratios And Adjustments," published April 1, 2019 (Ratios and Adjustments). The sector-specific accounting and analytical adjustments previously included in those paragraphs are now included in the Guidance supporting the Ratios and Adjustments criteria. We also updated the contacts list.
- On July 25, 2019, we republished this criteria article to make nonmaterial changes. We updated the contact information and updated several references to other criteria articles throughout the body of this article by removing the dates of publication. These dates are provided in the "Related Criteria" section.
- On Dec. 4, 2019, we republished this criteria article to make nonmaterial changes. We deleted paragraph 84 because it was superseded by "Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers" (liquidity criteria), published Dec. 16, 2014. The sector-specific liquidity adjustments previously included in that paragraph are now included in the guidance supporting the liquidity criteria. We also updated criteria references.
- On July 22, 2020, we republished this criteria article to make nonmaterial changes to update criteria references.
- On April 5, 2021, we republished this criteria article to make nonmaterial changes. We replaced the content of the "Industry risk" section (paragraphs 7-15) with a reference to the most recent "Industry Risk Assessments Update." In addition, we updated the "Related Research" section.

RELATED PUBLICATIONS

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- Assessing U.S. Utility Regulatory Environments, Nov. 7, 2007

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Related Research

- Industry Risk Assessments Update, Jan. 27, 2021

Related Guidance

- Guidance: Liquidity Descriptors For Global Corporate Issuers, Dec. 4, 2019
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