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Notching Of U.S. Investment-Grade Investor-Owned Utility Unsecured Debt Now Better Reflects Anticipated Absolute Recovery

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Standard & Poor's Ratings Services has reevaluated its application of notching criteria for U.S. investment-grade investor-owned utility operating company unsecured debt to better reflect the relatively strong recovery prospects of creditors in this sector. As a result, the senior unsecured debt of most utilities will now be rated the same as the corporate credit rating (CCR) almost uniformly, even when a considerable amount of secured debt is outstanding. This new approach does not affect unsecured debt ratings at unregulated affiliates, such as a holding company.

The table at the end of this article shows those ratings that reflect the updated application of notching criteria to utility companies.

Historically, we have approached notching issues from a "priority" perspective. That is, when a debt issue is junior to the company's other debt issues, and we therefore view it as having inferior recovery prospects, we notch that issue down from the CCR. We determine the number of notches by examining the relative amounts of secured and unsecured debt in an entity's capital structure. If sufficient secured debt existed to disadvantage the unsecured bondholders--for investment-grade companies, the guideline is 20% of assets--we adjust the rating on the lower-ranked debt to below the CCR.

But "absolute trumps relative"--and our criteria have evolved so that the notching analysis can also focus on the value of assets available in a bankruptcy and whether those assets are sufficient to satisfy claims, regardless of the debt's priority. This approach is beneficial for the debt ratings of utilities because the value of their regulated assets is resilient and because their ability to add debt is restricted. As a result, creditors of defaulted utilities have realized higher average recovery rates than the creditors of companies in other sectors. These characteristics were first reflected in Standard & Poor's approach to rating utility first mortgage bonds (FMB) when, in 1997, we began rating FMBs above the CCR based on an analysis of coverage of assets to satisfy all FMB claims. Secured debt issued by utility operating companies has traditionally been FMBs, but the same analysis would apply to other secured instruments. (In 2007, the utility team published an update on first mortgage bond recovery ratings. See "Changes To Collateral Coverage Requirements For ‘1+’ Recovery Ratings On U.S. Utility First Mortgage Bonds," published Sept. 6, 2007 on RatingsDirect.)

Standard & Poor's is now incorporating recovery principles in its approach to the unsecured debt of investment-grade utilities. If sufficient asset value is expected to satisfy the secured obligations and also unsecured debt (at least partially), that will receive more weight in our unsecured debt-notching decisions than the relative position of debt in the capital structure. If, in the rating committee's judgment, the absolute recovery that a unsecured holder would likely receive is above 30%, we will rate that issue at the CCR level. Standard & Poor's has deemed this threshold as material because it is substantially below the roughly 50% historical recovery rate realized by all debt classes, according to Standard & Poor's LossStats database of historical recoveries from 1987 to September 2008.

For investment-grade utilities, like other investment-grade issuers, we are not modeling a "path to default" or explicitly estimating recoveries given default given the remoteness and uncertainty surrounding these issues for investment-grade entities. Instead, rating committees employ broad guidelines on asset protection and ranking, with the addition of some recovery concepts. For utilities, we conclude enough asset value is likely to survive a utility bankruptcy to provide a typical utility unsecured bondholder with at least a 30% recovery rate. According to notching criteria, such anticipated recovery would allow the senior unsecured debt to be rated the same as the CCR.

In our view, this conclusion and the recovery prospects of unsecured regulated utility obligations benefit from several unique factors. First, utility assets are more likely to retain value in a bankruptcy scenario because of the essential nature of the service those assets provide. The experience of pure utility defaults (albeit few in number) shows that bankruptcy is normally caused by management missteps that lead to regulatory problems that in turn constrain cash flows. The situation is rehabilitated in the post-bankruptcy restructuring in a way that leaves regulated asset values essentially intact.

Second, most utilities must obtain regulatory permission to issue new debt, and this requirement acts as a constraint on the utilities' ability to add debt in the event of a default spiral.

Third, utility mortgage indentures restrict the issuance of FMBs to a percentage of bondable property, as defined in the indenture. The bondable property definition is normally tied to a utility's physical plant, and the percentage is typically 70% or less. Other indenture provisions may be more expansive, but usually not to a significant degree. These industry-specific and jurisdictional factors indicate that in most distressed situations we can reasonably anticipate recovery above 30% for utility unsecured debt.

Senior Unsecured Debt Ratings Raised On Nov. 5, 2008*

	To	From
ALLETE Inc.	BBB+	BBB
Atlantic City Electric Co.	BBB	BBB-
Carolina Power & Light Co. d/b/a Progress Energy Carolinas Inc.	BBB+	BBB
Cleveland Electric Illuminating Co.	BBB	BBB-
Connecticut Light & Power Co.	BBB	BBB-
Consumers Energy Co.	BBB-	BB+
Delmarva Power & Light Co.	BBB	BBB-
Detroit Edison Co.	BBB	BBB-
Florida Power Corp. d/b/a Progress Energy Florida Inc.	BBB+	BBB
Idaho Power Co.	BBB	BBB-
Kansas Gas & Electric Co.	BBB-	BB+
Monongahela Power Co.	BBB-	BB+
Niagara Mohawk Power Corp.	A-	BBB+
Northern States Power Co. (Minnesota)	BBB+	BBB
Northern States Power Wisconsin	A-	BBB+
NorthWestern Corp. (SD)	BBB	BBB-
Ohio Edison Co.	BBB	BBB-
PacifiCorp	A-	BBB+
Peoples Gas Light & Coke Co. (The)	A-	BBB+
Pennsylvania Power Co.	BBB	BBB-
Portland General Electric Co.	BBB+	BBB

Senior Unsecured Debt Ratings Raised On Nov. 5, 2008*(cont.)		
Potomac Electric Power Co.	BBB	BBB-
Public Service Co. of Colorado	BBB+	BBB
Rochester Gas & Electric Corp.	BBB+	BBB
San Diego Gas & Electric Co.	A	A-
South Carolina Electric & Gas Co.	A-	BBB+
Southern California Edison Co.	BBB+	BBB
Southern California Gas Co.	A	A-
Toledo Edison Co.	BBB	BBB-
Westar Energy Inc.	BBB-	BB+

*Does not include all affiliates affected.