Article Title: ARCHIVE | Criteria | Corporates | Utilities: U.K. Regulatory Ring-Fencing Risk For Utility Holding Companies: Standard & Poor's Approach Data: (EDITOR'S NOTE: — This criteria article is no longer current. It has been superseded by the criteria article titled, "Group Rating Methodology," published on Nov. 19, 2013.) In Standard & Poor's view, lenders to U.K. holding companies of regulated electricity distribution, transmission, and water businesses face a heightened risk of default if the corporate credit rating on the license-holding operating company is in the 'BBB' category. This is due to the risk of regulatory intervention to restrict cash flows between the operating company and holding company. This risk is particularly marked if the corporate credit ratings on the operating company fall to the investment-grade threshold of 'BBB-'. The U.K. utility ratings affected, in Standard & Poor's view, are Western Power Distribution Holdings Ltd. (BBB+/Negative/A-2), Midlands Electricity PLC (B/Watch Pos/--), Avon Energy Partners Holdings (Avon Energy; CC/Watch Neg/--), and Northumbrian Water Services Ltd. (BB+/Stable/--). This issue has been highlighted by the Office of Gas and Electricity Markets' (OFGEM) intervention in the case of Avon Energy, Midlands Electricity, and Aquila Networks PLC (BBB-/Watch Pos/A-3). Standard & Poor's expects that the Office of Water Regulation (OFWAT) will intervene in a similar way to OFGEM to protect water companies. Standard & Poor's applies greater differentiation to the issuer and issue ratings of regulated utility holding companies than to other parent companies owing to the increased risk of a trigger event if the rating of the operating company is close to the investment-grade threshold. Standard & Poor's will generally apply a two-notch differential in corporate credit ratings between the operating company and holding company if the group rating is in the 'BBB' range. The holding company will be rated lower. The notching of debt due to structural subordination is no longer applicable in this situation because the default risk is deemed to be different. Furthermore, structural subordination is an indication of post-default recovery as opposed to pure default risk. License conditions for both electricity and water utilities in the U.K. state that all reasonable endeavors should be used to ensure the retention of an investment-grade rating on the operating company. Moreover, OFGEM and OFWAT can impose changes to operating company license conditions that are designed to stabilize the operating company's credit quality by prohibiting or severely restricting the ability of operating companies to upstream cash to service holding company obligations. Standard & Poor's does not believe that the licenses of regulatory companies are sufficient to prevent the flow of cash out of the operating company. The servicing of holding company debt in most cases is almost entirely reliant on cash flows provided by the regulated entity. In Standard & Poor's view, regulatory oversight and protection increases as the rating on the licensed entity falls towards noninvestment grade. The corollary of this is that the anticipated protection for the licensed company is likely to be very detrimental to lenders to the holding company. Standard & Poor's believes that in the mid to low 'BBB' rating category, both OFGEM and OFWAT will increase their scrutiny of cash flow movements between the operating company and its related entities, particularly where there is significant outstanding debt at the holding company. It is unlikely that OFGEM or OFWAT would intervene if the ratings were in the mid to high 'BBB' category. Standard & Poor's expects, however, that the relevant regulator would take an active role in managing cash outflows from the operating company if the investment-grade rating were threatened. The two-notch gap between the ratings on the operating company and holding company is therefore a reflection of the proximity of the operating company's rating to noninvestment grade. If the rating were to fall further, the gap would be likely to widen. Furthermore, Standard & Poor's expects the regulators to look at ways of restricting upstream cash and dividend movements when the ratings on the operating company fall to 'BBB-' and the company's prospects are still negative. In the case of Aquila Networks, the movement cash out of the operating company has been restricted and is subject to prior regulatory approval. This protects the regulated operating company from servicing excessive holding company debt or returning cash to shareholders. The potential restriction of cash flows to the holding company significantly reduces the ability of the holding company to service debt or refinance maturing issues. In the case of Aquila Networks, the regulator's measures were taken to prevent the ultimate parent company, Aquila Inc. (B/Negative/--), from potentially draining cash from the company. The salient point of this interpretation of the U.K. regulatory framework is the proximity of a company's rating to the noninvestment grade threshold. Companies rated at 'A-' or higher are not affected. Nor are companies where there is diversity of regulation, namely a mixture of U.K. and non-U.K. regulation, or diversity of regulated and nonregulated revenue streams. The holding of both a U.K. water and a U.K. electricity license, however, is unlikely to provide adequate regulatory diversity to mitigate the notching of the holding company's corporate credit rating. Analyst E-Mail Addresses

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