Article Title: ARCHIVE | Criteria | Corporates | Utilities: Methodology: Differentiating The Issuer Credit Ratings Of A Regulated Utility Subsidiary And Its Parent Data: (EDITOR'S NOTE: — This criteria article is no longer current. It has been superseded by the corporate criteria article titled, "Group Rating Methodology," published on Nov. 19, 2013.) 1. The issuer credit rating of a wholly owned or substantially controlled utility subsidiary is linked to the credit quality of its parent. Regardless of Standard & Poor's Ratings Services' view of the subsidiary's standalone credit profile--i.e., its individual credit characteristics before giving consideration to the influence of owner(s) and affiliates--its rating usually is constrained to the level of its parent's credit quality as defined in our consolidated rating methodology (see below), However, there are various factors which combined can provide for rating differentiation of the utility subsidiary. SCOPE OF THE CRITERIA 2. Standard & Poor's is clarifying its criteria for analysis of its issuer credit ratings of regulated, investor-owned utilities and links to their parent-company credit quality. The article focuses on: The factors we consider when assessing whether a utility is insulated from its parent; and Our view of the impact on the ratings of each entity when insulation is established. 3. This article does not address the rating implications of creating "bankruptcy-remote" subsidiaries that may be rated as separate entities. This article also does not alter or supersede existing corporate ratings criteria. (Please see "Criteria: Principles of Corporate and Government Ratings," published on June 26, 2007, on RatingsDirect.) IMPACT ON OUTSTANDING RATINGS 4. No rating changes will result from the implementation of these criteria. EFFECTIVE DATE AND TRANSITION 5. These criteria are effective immediately. METHODOLOGY 6. Utility subsidiaries' ratings are linked to the consolidated group's credit quality because of the financial linkage of the parent to the subsidiary and the likelihood that, in times of stress or bankruptcy, the parent will consider the utility subsidiary as a resource to be used. Accordingly, our base-case financial analysis primarily focuses on the performance, cash flow, and balance sheet of the consolidated group. 7. In the case of regulated electric, gas, and water utilities, we have observed that, when the utility subsidiary itself is not the cause of the parent's financial difficulties, it is rare for the subsidiary to become directly entangled in a parent's bankruptcy proceedings. However, we believe there is a risk the parent will weaken the utility's financial profile to some degree, if its own financial condition begins to slide. 8. Often, nonconsolidation opinions, covenants, and regulatory considerations are cited as reasons why utilities should be viewed as insulated and independent of the parent. Individual factors usually are insufficient, but in combination, rating separation may be achieved, within limits. Achieving Insulation 9. In our view, certain situations justify the enhancement of regulated utilities' ratings--relative to the parent group's credit profile. The various "barriers" and factors that may serve to insulate the stronger entity, i.e., the utility, can be grouped as follows: Shared ownership/control of the stronger entity; Legislative/regulatory restrictions; Covenants; Nonconsolidation opinion, and Limited commitment to the group's weaker (typically, unregulated) subsidiaries/ventures. Shared ownership/control of the stronger entity 10. Structural limits on control of the entity can mitigate concerns over control of the rated entity by an owner that potentially may have incentives to siphon off its relative strength. The level of control can vary, depending on factors such as: Percentage of ownership; The nature of other owners, whether strategic or financial, concentrated or diffuse, relative financial capacity, active or passive, and their historical behavior; and Legal jurisdiction. 11. In cases of limited control over the entity by weaker owners, based on the factors above, the stronger entity's rating could approach its standalone credit profile, even if there is a large gap with respect to the related entities. Indeed, the rating could exceed that of all the owners, if we believe the owners have the ability to block each others' actions regarding the rated entity. Legislative/regulatory restrictions 12. In our opinion, restrictions on management behavior imposed by a legislature or utility commission--if designed to be supportive of credit quality--can contribute to insulating a utility from its parent. These restrictions vary by jurisdiction. 13. Regulatory restrictions pertain to operational and financial aspects of a utility--and often apply to holding companies, as well. Operational constraints usually refer to allowable business activities, affiliated transactions of the utility, and/or the amount of nonutility assets the parent can hold. Financial provisions include restrictions on intercompany guarantees and loans, dividends that can be paid by the utility (often tied to a financial test, such as minimum equity ratio), and/or requirements that the utility maintain certain credit ratings and access to capital. 14. The oversight and/or restrictions may be viewed as meaningful under our criteria, where they target specific credit quality parameters in its decisions. In the U.S., our published assessments of regulatory jurisdictions are used to help us evaluate the relative credit-supportiveness of the regulatory body's overall approach. (See "Assessing U.S. Utility Regulatory Environments," published Nov. 7, 2008, on RatingsDirect.) 15. For purposes of our analysis, we determine if the regulator has a demonstrated history of actively monitoring the financial condition of the utilities it regulates--and/or exacting what we view as meaningful consequences for utilities that violate their restrictions. For purposes of our criteria, we may view such regulation as more credit-supportive, if it is proactive. Similarly, we may view restrictions as more credit supportive where they are pre-emptive in nature--i.e., activated before serious financial harm to the utility has begun. Covenants 16. Protective covenants generally are designed to restrict the shifting of assets and liabilities between the two entities. Such covenants--found in loan agreements, indentures, security and collateral documents, and governing documents--include dividend restrictions, outright prohibition of certain transactions, and agreements regarding separateness. 17. Combined with other factors, covenants offer some support for rating differentiation; we therefore look for such covenants in a package designed to differentiate the two entities' credit quality. Notwithstanding the possibility of evading or overcoming covenant restrictions, we believe covenants normally discourage actions that would affect the stronger subsidiary. Nonconsolidation opinions 18. The likelihood of the subsidiary being drawn into a parent's bankruptcy through substantive consolidation is a relatively minor consideration, under our criteria, in determining the relationship between the ratings of a utility and its parent (see "Corporate Ratings Criteria 2006: Parent/Subsidiary Links" on RatingsDirect). We have observed that, typically, the relationship and ongoing interactions between a utility and its parent are structured and conducted in a way that satisfies the factual predicates, and assumptions that form the basis for a typical nonconsolidation opinion. However, a nonconsolidation opinion confirms our expectation that the risk of consolidation is relatively remote, and, therefore, such an opinion usually is part of a package of insulating enhancements. Limited commitment to the group's weaker (typically, unregulated) subsidiaries/ventures 19. Strategic alternatives may affect the risk of a group supporting its affiliates by drawing from the strength of other entities. For example, we believe there may be situations in which a parent could conclude that it makes more sense to sever the ties with a poorly performing affiliate--rather than look to the stronger members of the group to prop it up--if the economic, legal, strategic, and moral considerations allow for that. 20. In assessing how a parent would act with regard to a potentially weaker subsidiary, we take into account the two entities' various relationships: Strategic importance--integrated lines of business, critical supplier, or area of targeted growth; Management control; Shared name; Domiciled in same country; Common sources of capital; Management's stated posture; Track record of parent company in similar circumstances; and The nature of potential risks, e.g., litigation. 21. In our view, an electric generation subsidiary that mainly serves an affiliated utility's native load, is integrated as far as operational management, and shares the group name and financing sources would be at one end of the spectrum of parent/subsidiary relationships. A foreign subsidiary that has been hit by litigation the company believes is unjustified would be at the other end. Rating Impact 22. If the analysis indicates that our criteria require ratings differentiation, we consider both the relative positions of the standalone credit profiles of the parent and rated subsidiary(ies), and their position on the rating scale. Higher-rated entities are more likely to have similar ratings, because the impact of the package of insulating factors is limited. It is also unlikely, in our view, that even a combination of protective measures could elevate a subsidiary's rating to 'BBB-' or above, if the credit quality of the consolidated group is below 'BBB-'. 23. Most often, a package of regulatory considerations--operational and financial--are the main basis for ratings differentiation. In such cases, the ratings gap between the consolidated group credit profile and the utility is normally one or two notches. 24. One notch is most prevalent. This might occur in cases where the operations themselves are largely regulated, but the parent company has incurred an additional layer of debt. We would expect a nonconsolidation opinion to confirm the separateness of the parent and subsidiary. 25. A two-notch difference can occur when the holding company's weaker credit quality results from its ownership of smaller unregulated business activities that are largely unrelated to the core utility operations--and management has taken affirmative steps to distance the rest of the group from such non-utility subsidiaries. Actual evidence of that behavior--beyond the usual verbal assurances that management will not imperil the creditworthiness of the utility by supporting weaker operations--is necessary, pursuant to our criteria, to justify a difference of more than one notch. 26. A two-notch differentiation typically involves coupling the regulatory insulation with other legal elements, such as covenant restrictions and, of course, confirmation of a fact pattern supporting nonconsolidation (via a nonconsolidation opinion). 27. A greater differential--of three or more notches--requires either a shared/limited parent control (explained above) or the presence of structural features (example, e.g., independent directors) designed as barriers between the utility and its parent. The presence of such structural features, in our experience, is rare indeed, and the related criteria are outside the scope of this article. Corollary: The seesaw effect 28. To the extent that a utility subsidiary is insulated, our view regarding the credit quality and ratings of its parent/holding company is altered by the nature and degree of that insulation. The credit quality of the parent and/or group affiliates--relative to the group credit profile--moves in the opposite direction of the enhancement achieved by the stronger subsidiary. Generally, for purposes of our criteria, the greater the positive differentiation for the stronger subsidiary(ies), the greater the negative differentiation for the rest of the group--hence, the seesaw analogy. However, as far a reflecting these differences in actual ratings for the respective units, our approach would not be entirely mechanical, because the materiality of the various units and diversification within the group structure could play roles in the rating outcomes. RELATED RESEARCH Corporate Ratings Criteria 2008, April 15, 2008 Key Credit Factors: Business And Financial Risks In The Investor-Owned Utilities Industry, Nov. 26, 2008 Assessing U.S. Utility Regulatory Environments, Nov. 7, 2008 U.K. Regulatory Ring-Fencing Risk For Utility Holding Companies: Standard & Poor’s Approach, July 8, 2003 These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as Standard & Poor's Ratings Services' assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.