



Dominion
Bond
Rating
Service

Rating Utilities (Electric,
Pipelines & Gas
Distribution)





DBRS Rating Approaches

Rating Utilities (Electric, Pipelines & Gas Distribution)

The following is an addition to the DBRS rating methodology for industrial companies (see General Overview), which adds some additional factors that are important considerations for DBRS in deriving credit ratings for Pipelines, Electric and Gas Utilities. For a full understanding of the rating methodology used for these industries, the reader should refer to this document and the General Overview. (Note: ratings of government-owned utilities whose debt is guaranteed are the same as the government rating.)

Industry Factors

Regulatory factors

In assessing this industry, regulatory factors are key considerations that have a large impact in determining the creditworthiness of a particular entity. Provincial/state regulators typically have jurisdiction over entities that operate in a single province/state. The federal regulator typically has jurisdiction over utilities whose operations cross provincial/state boundaries. Typically, regulated utilities operate on a variation of cost-of-service methodology. The Regulator sets the appropriate capital structure for the regulated entity, and defines the allowed return on equity ("ROE"). Variations of this method allow the utility to earn "excess" returns based on performance-based regulation ("PBR") models. As a result, regulated utilities generally have a higher degree of financial leverage and lower interest coverage ratios than equivalently rated industrial companies. However, higher ratings for regulated utilities are justified by the stability of their capital structures and earnings.

Competitive environment

Historically, Canadian regulated utilities operated as monopolies within their service areas. In order to deal with market power concerns, pricing decisions are determined in conjunction with the appropriate regulator. Competitive pressures tend to come from alternative sources of energy rather than alternative suppliers. By contrast, in the United States, competition is much more intense. The U.S. electricity industry is undergoing de-regulation, while pipeline companies are subject to considerable competition from alternative suppliers. As this trend expands into Canada, ratings will likely be affected.

Supply/demand considerations

The provision of regulated services depends on the presence of adequate supplies of raw material to meet demand. In the case of pipeline companies, recoverable oil and gas reserves continue to be substantial. However, the degree to which pipeline capacity is fully utilized depends upon the degree of success of oil and gas producers' drilling results. For electric utilities, generation of sufficient electricity to meet demand is paramount. In Canada, the limited degree of inter-connection between territories gives the purchase of outside power a limited role. This is much less of an issue in the United States.

Company Specific Factors

Regulated vs. Non-regulated Activities

Companies that generate most of their earnings from regulated activities are typically more stable and predictable than those that have significant non-regulated operations.

Domestic vs. Foreign Operations

Expansion into international markets outside of North America exposes a company to additional risks, including market, currency and political risk.

Capital Spending Program

Capital spending analysis provides an understanding of a company's operating strategies, growth plans and areas under active investment and divestment. Cash flow adequacy is viewed from the standpoint of a company's ability to finance capital maintenance requirements internally, as well as its ability to finance capital additions. An important dimension of capital spending is the extent of a company's flexibility to alter the timing without permanent impairment of its operations.

Coverage Ratios

Given the fact that the capital structure and allowed ROE is typically affected by regulatory decisions, a Utility's ability to control costs is a strong determinant of interest and fixed charges coverage ratios. Coverage ratios are negatively impacted by lower allowed ROEs, and are also impacted by the method used to account for deferred income taxes.

Qualitative Factors

These include the following: (i) Customer mix (e.g., residential, commercial, industrial) and economic strength of the business franchise area; and (ii) Management expertise.

Non-Regulated Activities

In recent years, many of the larger energy companies, particularly in the United States, have diversified into non-regulated operations in order to increase their profitability. However, this also entails accepting additional business risk. Non-regulated operations typically include the following:

- *Field Services* (e.g., natural gas gathering, processing and treatment, natural gas liquids transportation, and fractionation and storage)
- *Energy Marketing and Trading* (e.g., transactions involving a wide range of energy commodities, price-risk management services through financial instruments (i.e., derivatives))
- *Wholesale Energy Services* (e.g., construction and sale of merchant power plants, both domestically and internationally)
- *Oil and Gas Exploration and Production* (e.g., natural gas production to provide a physical hedge to trading activities, or for use in electricity generation)
- *Electricity Generation* (merchant power or long-term contracts, base load versus peak load)
- *Broadband Services* (e.g., using pipeline right-of-way to lay fibre optic cable systems)

Each of these activities (and others not listed above) must be evaluated on their own merits. This evaluation typically involves the competitive factors in each segment, as well as an assessment of how each individual segment contributes to the operations of the entire company. For example, a company with its own infrastructure (e.g., natural gas production, gathering and processing, transmission, distribution and electricity generation) would be in a much better position to derive value (and mitigate risk) along the entire energy value chain than would a company with stand-alone operations in any one area. In addition, given the higher business risk inherent in non-regulated activities, companies with larger exposures to non-regulated activities would be expected to have lower financial risk (i.e., lower balance sheet leverage and higher fixed charges coverage ratios) as a compensating factor in order to have a comparable credit rating.