



Methodology

*Rating Companies in the North  
American Energy Utilities (Electric  
and Natural Gas) Industry*

MAY 2011



*Insight beyond the rating.*

---

## CONTACT INFORMATION

**Michael J. Caranci**

Managing Director, Energy  
+1 416 597 7304  
mcaranci@dbrs.com

**Kent Wideman**

Chief Credit Officer  
+1 416 597 7535  
kwideman@dbrs.com

---

DBRS is a full-service credit rating agency established in 1976. Privately owned and operated without affiliation to any financial institution, DBRS is respected for its independent, third-party evaluations of corporate and government issues, spanning North America, Europe and Asia. DBRS's extensive coverage of securitizations and structured finance transactions solidifies our standing as a leading provider of comprehensive, in-depth credit analysis.

All DBRS ratings and research are available in hard-copy format and electronically on Bloomberg and at DBRS.com, our lead delivery tool for organized, Web-based, up-to-the-minute information. We remain committed to continuously refining our expertise in the analysis of credit quality and are dedicated to maintaining objective and credible opinions within the global financial marketplace.



---

# Rating Companies in the North American Energy Utilities (Electric and Natural Gas) Industry

---

## TABLE OF CONTENTS

Introduction to DBRS Methodologies	4
Business and Financial Risk Overview	4
Stage 1: Industry Business Risk Rating for the North American Energy Utilities (Electric and Natural Gas) Industry	6
Industry Profitability and Cash Flow	6
Industry Competitive Landscape	6
Industry Stability	6
Industry Regulation	6
Other Inherent Industry Considerations	7
Stage 2: Issuer Rating	7
Business Risk Profile	7
Financial Risk Profile	7
Company-Specific Business Risk Factors	8
Primary Factors	9
Regulatory/Contractual	9
Business Mix and Diversification	10
Franchise Area	10
Competitive Environment	10
Additional Factors	10
Capital Spending	10
Supply/Demand Considerations	11
Customers/Shippers	11
Ownership	11
Environmental Issues	11
Retail Exposure	12
Political Risk	12
Common Business Considerations	12
Country Risk	12
Corporate Governance	12
Company-Specific Financial Risk Factors	13
Key Metrics	13
Overall Considerations in Evaluating a Company's Financial Risk Profile	14
Earnings	14
Cash Flow and Coverage	14
Balance-Sheet and Financial Flexibility Considerations	15
Stage 3: Rating the Security	15
Appendix	16
Industry Business Risk Ratings	16
Industry Profitability and Cash Flow	16
Industry Competitive Landscape	17
Industry Stability	17
Industry Regulation	17
Other Inherent Industry Considerations	17
Industry Business Risk Rating Definitions	18
Interrelationship between Financial and Business Risk	19
Definition of Issuer Rating	19
Short-Term and Long-Term Ratings	19



---

## Introduction to DBRS Methodologies

---

- In general terms, DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. They are opinions based on an analysis of historic trends and forward-looking measurements that assess an issuer's ability and willingness to make timely payments on outstanding obligations (whether principal, interest, dividend or distributions) with respect to the terms of an obligation.
- DBRS rating methodologies include consideration of general business and financial risk factors applicable to most industries in the corporate sector as well as industry-specific issues and more subjective factors, nuances and intangible considerations. Our approach is not based solely on statistical analysis but includes a combination of both quantitative and qualitative considerations.
- The considerations outlined in DBRS methodologies are not intended to be exhaustive. In certain cases, a major strength can compensate for a weakness and, conversely, there are cases where one weakness is so critical that it overrides the fact that the company may be strong in most other areas.
- DBRS rating methodologies are underpinned by a stable rating philosophy, which means that in order to minimize the rating changes due primarily to economic changes, DBRS strives to factor the impact of a cyclical economic environment into its rating as applicable. Rating revisions do occur, however, when it is clear that a structural change, either positive or negative, has transpired or appears likely to transpire in the near future.
- As a framework, DBRS rating methodologies consist of several components that together form the basis of the ultimate ratings assigned to individual securities. Assessments typically include the industry's business risk profile, the company's general business risk profile, the company's financial risk profile and considerations related to the specific security.
- To some extent, the business risk and financial risk profiles are interrelated. The financial risk for a company must be considered along with the business risks that it faces. In most cases, an entity's business risk will carry more weight in the final issuer rating than will its financial risk.

---

## Business and Financial Risk Overview

---

- On a high-level macro basis, DBRS has a consistent approach to determining the issuer rating of an entity that is common across many industries. (See the appendix for the definition of "issuer rating.") Our high-level approach can be broken into three stages, as shown on the opposite page.
- Where applicable, DBRS uses the concept of business risk ratings (BRRs) as a tool in assessing the business strength of both industries and individual companies within many methodologies across the corporate finance area. DBRS typically assesses five areas to establish the overall BRR for an industry:
  - Profitability and cash flow.
  - Competitive landscape.
  - Stability.
  - Regulation.
  - Other inherent industry considerations.
- Although there is an overlap in some instances (to some degree, in the long term, all five factors tend to relate to profitability and stability), DBRS has found that considering these five measures in a separate fashion is a useful way of approaching this analysis.
- Using the same factors across different industries provides a common base with which to compare the business risks of various industries, even when they are distinctly different. In all cases, DBRS uses historic performance and our experience to determine an opinion on the future, which is the primary focus. For additional discussion on industry BRRs, please refer to the Industry Business Risk Ratings and Industry Business Risk Rating Definitions sections in the appendix.



- It is important to note that the ratings for company-specific business and financial risks as provided under Stage 2 of this document should not be taken as final issuer ratings. For example, an individual company may fit into the “A” range with respect to the analysis of its business risk, but its financial metrics could be more in the BB category. It would be incorrect to believe that the final issuer rating in this case would be either “A” or BB. In determining the final issuer rating, both of these two major areas must be considered. For additional discussion on this topic, please refer to the Interrelationship between Business and Financial Risk section in the appendix.

---

### Three Stages of DBRS Rating Analysis

---

#### Stage 1: Industry Business Risk Rating

Consider the overall business risk rating (BRR) for the industry.

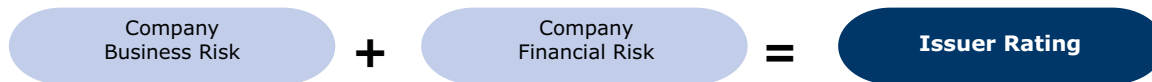


#### Stage 2: Issuer Rating

Consider the strength of the individual issuer:

- (a) First assessing how the company’s BRR compares with the industry BRR.
- (b) Then assessing the company’s financial risk.

Taken together, these factors will determine the company’s issuer rating.



The **long-term rating** puts more emphasis on business risk than the short-term rating does.



The **short-term rating** stresses financial risk as well as business risk, but places more emphasis on financial risk and liquidity than the long-term rating does.

#### Stage 3: Rating the Security

Consider covenant and ranking issues that exist for specific securities, using the issuer rating to determine specific security ratings.





---

## Stage 1: Industry Business Risk Rating for the North American Energy Utilities (Electric and Natural Gas) Industry

---

- This methodology applies to North American companies with significant regulated energy utility operations (i.e., electric generation, distribution or transmission, and/or natural gas distribution) that may also have non-regulated operations in other segments of the energy industry (e.g., non-regulated electricity generation, energy marketing and trading). DBRS evaluates each of these business segments individually, as well as in the context of the business risk of the diversified company. This methodology does not apply to pipeline or diversified energy companies (covered under the *Rating North American Pipeline and Diversified Energy Companies* methodology), or entities that generate primarily non-regulated power or power generation projects, which are covered in the *Rating Companies in the Non-Regulated Electric Generation Industry* and *Rating Project Finance* methodologies, respectively.
- For the North American energy utilities (electric and natural gas) industry, DBRS views the BRR as being “A”, noting that this range applies to entities that primarily have regulated utility businesses. The single most important factor that drives this strong rating range is the stability provided by regulation. Based on the five major categories used by DBRS in assessing industry BRRs, the rationale for this assessment is as follows.

### INDUSTRY PROFITABILITY AND CASH FLOW

- The level of profitability and cash flow remains moderately below average versus other industries, a trade-off for the stability provided by regulation. The profitability of most utilities is largely constrained by the regulatory model under which rates are set (typically either traditional cost of service or some form of performance-based rates).
- While regulated utilities often do not exactly earn their “regulatory-approved” return on equity (ROE), deviations from approved levels are generally small. However, approved ROE levels are quite modest (currently in the range of 8% to 10%), due to the linkage between government bond yields and approved ROEs in many regulatory jurisdictions.

### INDUSTRY COMPETITIVE LANDSCAPE

- The competitive landscape is below the average of other industries. A fully-regulated energy utility generally competes only against other sources of energy, not other utilities. Rather, the regulator is the “competition”; that is, a regulated energy utility is afforded an opportunity to recover its costs and earn a return on capital, with no direct competition, in exchange for regulatory oversight and a general ceiling on profitability.
- Additionally, significant barriers to entry exist, typically through some combination of the monopoly franchise areas and the highly capital-intensive nature of the businesses.

### INDUSTRY STABILITY

- The existence of regulatory business models (and possibly contractual support) results in a level of stability that is well above that found in most other industries, affording significant levels of protection against variability that would otherwise be caused by wider economic considerations. While energy utilities are not immune to the negative impacts of a struggling broader economy, the variability in an energy utility’s operating and financial results are generally much less volatile than in most other industries.

### INDUSTRY REGULATION

- The industry is highly regulated (and/or contracted) on an economic basis, which is the major positive factor in the overall BRR. The industry is also subject to various levels of operational regulation. The trade-off for little or no direct competition (except from alternative sources of energy) and monopoly franchise areas is that the rates utilities can charge customers are generally set by regulators.
- While this can place an effective ceiling on the level of profitability, it affords the utility tremendous stability and protection for fluctuations in both revenues and costs.

## OTHER INHERENT INDUSTRY CONSIDERATIONS

- Overall, risks are below average for most energy utilities. The basic processes of producing, transmitting and distributing electricity, and distributing natural gas, are reasonably stable and have not changed significantly over time. The risk of environmental regulation is evolving, particularly for the electric industry; however, for a regulated energy utility, future cost increases attributable to environmental regulation would be expected to be recovered from ratepayers.

---

## Stage 2: Issuer Rating

---

To move from the generic industry BRR toward the issuer rating for a specific company, two tasks must be performed. Specifically, we must determine the business risk and the financial risk for the individual company.

### BUSINESS RISK PROFILE

- The business risk profile of the issuer may be better or worse than the industry average due to the presence of unique attributes or challenges that exist at the issuing entity. While not exhaustive, the list of critical factors outlined in the previous section could result in a specific issuer rating being different from the industry BRR.
- This methodology also provides some guidance on which factors are considered the most critical for the industry in question. Issuers may also have meaningful business lines in addition to the base business that extend beyond their most prominent industry, which could add significant attributes or challenges.

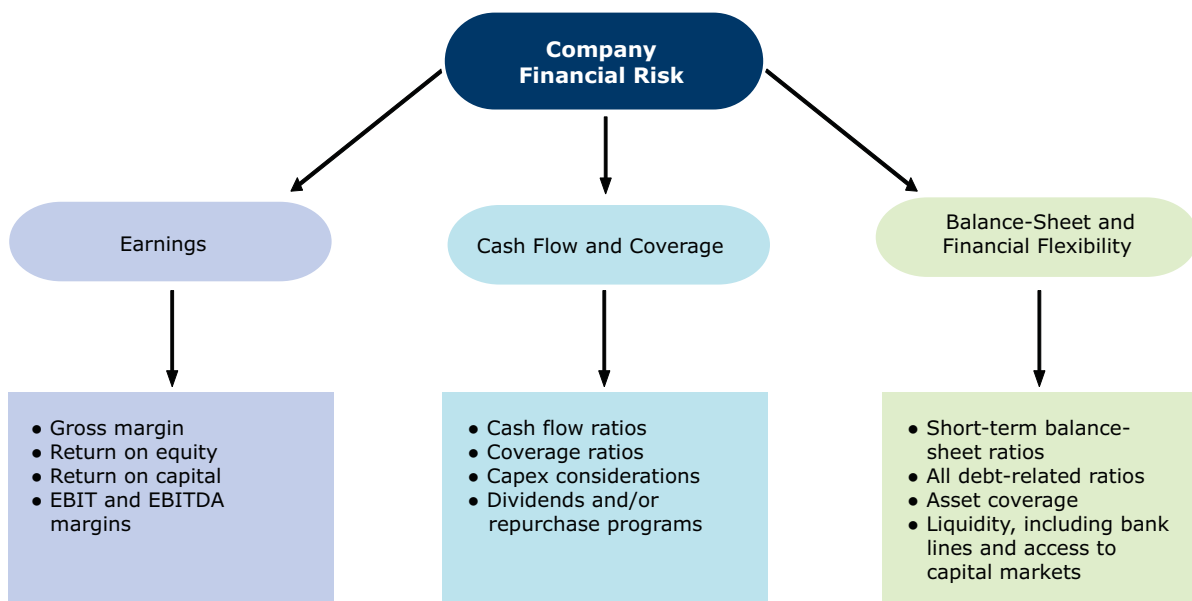
### FINANCIAL RISK PROFILE

- The graphic below is a visual display of the key financial risk profile considerations that are discussed in the Company-Specific Financial Risk Factors section of this methodology, although even the detail provided there is not meant to be exhaustive.
- The discussion will note that DBRS often makes calculation adjustments in key ratios for risks related to a variety of areas. In some cases, a relationship with a parent or associated company will also be important.

---

#### Key Financial Risk Metrics

---





## Company-Specific Business Risk Factors

- We now consider if an individual company in the North American energy utilities (electric and natural gas) industry would be better, worse or the same as the industry BRR. Our focus here is on the critical business risk factors that relate to this industry in particular. The five critical factors used to determine the industry BRR are applied by DBRS to compare numerous industries and are thus more general in nature.
- By analyzing these key drivers (which will vary on an industry-by-industry basis), the essential strengths and challenges of each industry are captured in an accurate fashion, and transparency is provided. The analysis below is connected to the industry BRR in that the industry BRR establishes where an average company would be considered to score on the matrix. For example, an industry with a BRR of BBB would mean that the following matrix describes the scoring of an average company within the BBB column.

### Company-Specific Business Risks – Critical Factors

Rating Business Strength	AA Exceptional	A Superior	BBB Adequate	BB Weak
<b>Regulatory/ Contractual</b>	<ul style="list-style-type: none"> <li>• Exclusively regulated operations, no volume or fuel risk, insignificant regulatory lag, highly supportive regulator.</li> </ul>	<ul style="list-style-type: none"> <li>• Predominantly regulated operations, minimal volume or fuel risk, minimal regulatory lag, consistently supportive regulator.</li> </ul>	<ul style="list-style-type: none"> <li>• Largely regulated operations, some volume or fuel risk, some regulatory lag, supportive regulator.</li> </ul>	<ul style="list-style-type: none"> <li>• Some regulated operations, meaningful volume or fuel risk, meaningful regulatory lag, poor regulatory support.</li> </ul>
<b>Business Mix and Diversification</b>	<ul style="list-style-type: none"> <li>• Entirely regulated operations or contracted long-term.</li> <li>• Largely “wires” with modest (if any) power generation.</li> <li>• Primarily electric transmission and/or distribution.</li> </ul>	<ul style="list-style-type: none"> <li>• Large majority of operations are regulated or contracted long-term; small non-regulated operations with lower-risk business profiles (e.g., contracted, integrated).</li> <li>• “Wires” or gas distribution, or an integrated utility with very timely and certain fuel recovery.</li> </ul>	<ul style="list-style-type: none"> <li>• Mix of regulated/contracted and non-regulated activities; non-regulated operations expected to have moderate risk with contracts and/or some value chain integration.</li> <li>• Integrated utility with some fuel cost recovery lag or significant power generator with moderate risk profile.</li> </ul>	<ul style="list-style-type: none"> <li>• Majority higher-risk, non-regulated activities. Minimal diversification, with concentration in higher-risk generation (i.e., minimal contracts or integration).</li> </ul>
<b>Franchise Area</b>	<ul style="list-style-type: none"> <li>• Strong and consistent levels of load growth.</li> <li>• Economically vibrant service territory.</li> <li>• Customer mix primarily residential and commercial.</li> </ul>	<ul style="list-style-type: none"> <li>• Reasonable load growth generally tracking the broader economy.</li> <li>• Economically strong service territory.</li> <li>• Customer mix heavily weighted toward residential and commercial.</li> </ul>	<ul style="list-style-type: none"> <li>• Minimal load growth.</li> <li>• Economically stagnant service territory.</li> <li>• Customer mix a balance of residential, commercial and industrial.</li> </ul>	<ul style="list-style-type: none"> <li>• Consistent load declines.</li> <li>• Economically weak service territory.</li> <li>• Customer mix weighted toward cyclical industrials.</li> </ul>
<b>Competitive Environment</b>	<ul style="list-style-type: none"> <li>• Competition only from other forms of energy, with the utility maintaining a significant competitive cost advantage.</li> </ul>	<ul style="list-style-type: none"> <li>• Competition only from other forms of energy, with the utility maintaining a competitive cost advantage.</li> </ul>	<ul style="list-style-type: none"> <li>• Competition only from other forms of energy; however, the utility maintains only a marginal cost advantage.</li> </ul>	<ul style="list-style-type: none"> <li>• Competition only from other forms of energy; however, utility is at a cost disadvantage.</li> </ul>



- Energy utilities are typically characterized by very low business risk and aggressive but relatively stable financial metrics based on supportive regulatory frameworks and/or contractual arrangements. Competitive forces are typically low relative to other industries.
- Given their monopoly position within a franchise area, the size of a utility plays less of a role in determining its creditworthiness than for other industries. Smaller utilities can be disadvantaged, however, in terms of more limited access to capital. Furthermore, unlike many other industries, the prospect for future growth is not as significant a factor in the creditworthiness of an energy utility if a “steady state” is maintained; that is, capital expenditures result in a stable rate base and a stable capital structure is maintained.
- As a result of the stability that can be provided by the regulated and/or contractual frameworks, energy utilities typically have a much higher degree of financial leverage and lower interest coverage ratios than similarly-rated industrial companies. However, higher ratings for energy utilities are typically justified by the low variability inherent in their business risk, capital structure, and earnings and cash flow generating ability.
- A company with regulated energy utility operations (i.e., electric generation, distribution or transmission, and natural gas distribution) may also have non-regulated operations in other segments of the energy industry (e.g., non-regulated electricity generation) and DBRS evaluates these business segments individually, as well as in the context of the business risk of the diversified company.
- Utility earnings and cash flows are generally considered much more stable and predictable than cash flows from non-regulated activities.

## PRIMARY FACTORS

### *Regulatory/Contractual*

- Regulatory and contractual factors are a key consideration in determining the creditworthiness of an energy utility. Provincial/state regulators typically have jurisdiction over utilities that operate in a single province/state. Federal regulators typically have jurisdiction over utilities where operations cross provincial/state boundaries.
- Energy utilities typically operate under a methodology in which the regulator determines an appropriate capital structure for the regulated utility and defines the allowed ROE; these are two of the variables (along with depreciation expense, operating and maintenance costs, interest expense, taxes, etc.) that go into building up a utilities revenue requirement through a “bottom-up” approach.
  - Variations of this method can provide the regulated utility with the opportunity to earn and retain some portion of “excess” returns based on performance-based regulation (PBR) or some other incentivized model.
  - Alternatively, operations could be governed by long-term contracts (e.g., for power generation) that reduce or eliminate volume and/or price risk for a fixed but potentially long period of time.
- The extent of volume variance and fuel-price flow-through protection are also key factors in regulatory analysis. The existence of a mismatch between revenues and fuel and/or purchase power costs (i.e., selling fixed and buying floating) can have a major impact on the stability of a utility. DBRS also considers whether the regulatory framework is flexible and responsive to changing industry conditions (e.g., timeliness of commodity price pass-through decisions where applicable, or changing ROE requirements).
- However, being a utility does not ensure income stability. There are many examples of regulatory lag, which can slow cost recovery and negatively affect a firm’s performance, particularly in the areas of fuel cost recovery and multi-year capital expenditure programs.
- Furthermore, the support provided by individual regulatory bodies varies by jurisdiction. DBRS generally views Canadian regulation as more supportive than that of the United States. However, approved levels of ROE and equity thickness are generally higher in the United States than in Canada.



### ***Business Mix and Diversification***

- For the electric-related utilities, there are three broad business areas: generation, transmission and distribution. Some utilities are fully integrated and participate in all three, while others may be involved in one or two segments.
- Generally, DBRS views transmission as the area with the least business risk, followed very closely by distribution, followed by generation. Within the electric generation segment, the type of generation (nuclear, coal, natural gas, hydroelectric, wind, etc.) also factors into the determination of business risk; for example, nuclear generation is viewed as having the highest level of operating risk, with hydroelectric the lowest.
- The extent of non-utility operations is critical, as these business lines typically entail accepting additional business risk for higher potential financial returns.
  - Non-utility operations often include non-regulated electricity generation, energy marketing and trading, and energy retailing.
  - Non-regulated activities must be evaluated on their own merits, involving an examination of the competitive factors in each segment and assessing how each individual segment contributes to the operations of the entire company.
  - For example, a company with its own infrastructure (e.g., 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 non-regulated 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 maintain lower financial risk (i.e., lower balance sheet leverage and higher coverage ratios) as a compensating factor in order to have a comparable credit rating.

### ***Franchise Area***

- Given the significant penetration rates for utilities (with electric being virtually 100%) and the close tie between energy consumption and economic growth (North American electricity demand generally tracks the level of economic growth/contraction), the economic state of the franchise area can significantly affect a utility both in the short and long term. Generally, utilities with a higher proportion of residential and commercial customers in their customer composition possess the ability to better weather economic downturns and demonstrate more stable operating performances than utilities with a greater exposure to industrial customers.
- For example, although load growth may be achieved through increased demand by industrial customers, the cyclical nature to which this segment of a utility's customer base is subject to may render such growth inconsistent vis-à-vis load growth via residential or commercial customers.

### ***Competitive Environment***

- Historically, Canadian energy utilities have operated as monopolies within their service areas. In order to mitigate market power concerns, pricing decisions are determined in conjunction with the appropriate regulator, with input also received from interested parties (e.g., customer groups). Competitive pressures tended to come from alternative sources of energy rather than from alternative suppliers. The deregulation movement, embraced in some fashion by approximately half of the U.S. states, and a few Canadian provinces, has come firmly to a standstill after considerable activity in the late 1990s to early 2000s.
- Critical scale can provide competitive advantages in areas such as cost and operational efficiency, supply discounts, market profile and customer perception. A large equity base can provide additional comfort from one-time earnings hits, and larger firms often have more funding options in times of financial stress.

## **ADDITIONAL FACTORS**

### ***Capital Spending***

- Energy utilities are capital-intensive businesses. An energy utility might undertake large capital projects in order to either meet growing demand in a high-growth franchise area or significantly refurbish aging assets. This could potentially lead to cost overruns and weaker financial metrics, at least during the growth phase.



- All things being equal, a large multi-year growth project would likely entail more execution risk and credit metric deterioration than a small project with a shorter construction period. For larger multi-year projects, credit metric deterioration is largely attributable to the fact that while debt would typically be used to (at least partially) fund expenditures, cash earnings are generally not realized until the assets are placed in service.
- Therefore, the existing asset base must produce the cash required to service the incremental debt associated with the new assets until those assets are placed in service. If construction-related interest expense is capitalized, this can understate an entity's cash interest expense on the income statement as the capitalized portion is removed to arrive at the net interest expense.
- Other key aspects of capital spending analysis include the cash flow adequacy to finance ongoing necessary maintenance requirements, and a company's flexibility in altering the timing of projects. Capital spending analysis provides an understanding of a company's operating strategies, growth plans and areas under active investment and divestment.
- For utilities undergoing very significant multi-year capital expansion programs, capital spending may be considered a Primary Rating factor. This would be particularly relevant for significant nuclear generation development.

### *Supply/Demand Considerations*

- The provision of energy utility services depends on the presence of adequate supplies of energy (e.g., natural gas and electricity) to meet end-user demand. For electric utilities, generation of sufficient electricity to meet demand is paramount. In Canada, the limited degree of interconnection between provinces results in a limited role for purchased power. This is less of an issue in the United States.

### *Customers/Shippers*

- With respect to the distribution of electricity and natural gas, customer mix can have implications, influencing the entity's volume exposure caused by weather (residential and commercial customers) and economy-related (largely industrial customers) risks.
- Electric generation not subject to regulation operates on a commercial basis as either merchant (i.e., full price and volume risk), or enters into some type of contractual off-take or hedging arrangement. Similar to the pipelines, counterparty risk is critical for those with contractual or hedging arrangements.

### *Ownership*

- An energy utility's ownership can be an issue, particularly in the United States, where regulatory protection tends to be weaker than in Canada. An energy utility owner that is experiencing financial difficulties in its other operations might be tempted to use regulated assets to shore up its other operations, thereby weakening the financial position of the regulated energy utility.
- The existence of a highly rated parent typically does not result in a "lift" to a stand-alone utility's rating. However, DBRS may impute some level of support in a utilities rating if it is owned by a highly-rated city, despite no explicit guarantee being in place, given the potential unique circumstances of the city/utility relationship.

### *Environmental Issues*

- DBRS assesses the extent to which energy utilities face government laws and regulations that can have an impact on a company's business and prospects. Regulated utilities may either be a direct source of greenhouse gas emissions (e.g., thermal power producer) or may transport energy derived from sources that produce emissions (e.g., a wires utility moving third-party power through its lines).
- In light of the global push toward lower emissions, DBRS views this risk and its associated cost as growing over time, although likely to be passed on to the end-customer. While not viewed as a significant rating factor for a fully regulated utility, significant environmental compliance costs could increase liquidity needs through recovery lags, and could increase rates for end-users.
- There are a number of alternative solutions that could be put in place, including cap and trade, carbon taxation, direct emissions limits, or, in the electric generation sector, renewable energy portfolio standards.



### *Retail Exposure*

- Participants in the retail sector of the electricity industry who do not own generating assets can, depending on commercial arrangements, be exposed to significant market risk; key areas of analysis therefore include hedging policies, counterparty risk and the size of the operation.

### *Political Risk*

- Energy utilities are essential service providers that have an impact on the general economy and society as a whole. As such, while it does not typically occur on a frequent basis, there is always the risk of political interference (which is different from regulatory risk). Political interference has been seen in the past pertaining to such areas as overall market structures, environmental considerations and energy costs. Future environmental regulation (discussed above) will also be politically driven.
- Politics, as well as constituent buy-in, can also play a major factor (positive or negative) in practical matters such as permitting, particularly in the siting of new electric transmission infrastructure.

## COMMON BUSINESS CONSIDERATIONS

- There are two major considerations that were not included with the prior analysis but can have a meaningful impact on an individual company in any industry: country risk and corporate governance (which includes management). These areas tend to be regarded more as potential negative issues that could result in a lower rating than otherwise would be the case, although DBRS would certainly consider exceptional strength in corporate governance as a rating attribute.
- In most cases, our focus on the two areas is to ensure that the company in question does not have any meaningful challenges that are not readily identifiable when reviewing the other business risk considerations and financial metrics outlined in this methodology.

### *Country Risk*

- Governments often intervene in their economies and occasionally make substantial changes that can significantly affect a company's ability to meet its financial obligations; therefore, considerations include the company's main location or country of operation, the extent of government intervention and support and the degree of economic and political stability.
- As such, the sovereign rating itself may in some cases become a limiting factor in an entity's rating, particularly when the sovereign has a lower rating and the entity does not have meaningful diversification outside its domestic economy.

### *Corporate Governance*

- Effective corporate governance requires a healthy tension between management, the board of directors and the public. There is no single approach that will be optimal for all companies.
- A good board will have a profound impact on a company, particularly when there are significant changes, challenges or major decisions facing the company. DBRS will typically assess factors such as the appropriateness of board composition and structure, opportunities for management self-interest, the extent of financial and non-financial disclosure and the strength or weakness of control functions. For more detail on this subject, please refer to the DBRS criteria *Evaluating Corporate Governance*.
- With respect to the pivotal area of management, an objective profile can be obtained by assessing the following: the appropriateness of core strategies; the rigour of key policies, processes and practices; management's reaction to problem situations; the integrity of company business and regulatory dealings; the entity's appetite for growth, either organically by adding new segments or through acquisition; its ability to smoothly integrate acquisitions without business disruption; and its track record in achieving financial results. Retention strategies and succession planning for senior roles can also be considerations.



## Company-Specific Financial Risk Factors

### KEY METRICS

- Recognizing that any analysis of financial metrics may be prone to misplaced precision, we have limited our key metrics to a small universe of critical ratios. For each of these ratios, DBRS provides a range within which the issuer's financial strength would be considered as supportive for the same level of business risk as the North American energy utilities (electric and natural gas) industry. For example, a company where the outlook for both business risk and financial risk metrics falls within the BBB category would, all else being equal, be expected to have an issuer rating in the BBB range.
- To be clear, the ratings in the matrix below should not be understood as the final rating for an entity with matching metrics. This would only be the case to the extent that the business risk of the company and a wide range of other financial metrics were also supportive. The final rating is a blend of both the business risk and financial risk considerations in their entirety.
- The following table represents financial metrics generally related to an entity with significant regulated energy utility operations (i.e., electric generation, distribution or transmission, and/or natural gas distribution), with minimal exposure to non-regulated energy operations (i.e., non-regulated electricity generation, energy market and trading). Significant exposure to non-regulated operations would result in increasingly stringent financial metric criteria at the various rating levels.

#### North American Energy Utilities (Electric and Natural Gas) Industry Financial Metrics

Key Ratio	AA	A	BBB	BB
Cash flow-to-debt	> 17.5%	12.5% to 17.5%	10% to 12.5%	< 10%
Debt-to-capital	< 55%	55% to 65%	65% to 75%	> 75%
EBIT-to-interest	> 2.8x	1.8x to 2.8x	1.5 to 1.8x	< 1.5x

DBRS notes that utilities rated below investment grade are typically rated as such due to heightened business risk levels rather than for credit metric reasons.

- While the data in the above table are recognized as key factors, they should not be expected to be fully adequate to provide a final financial risk rating for any company. The nature of credit analysis is such that it must incorporate a broad range of financial considerations, and this cannot be limited to a finite number of metrics, regardless of how critical these may be.
- DBRS ratings are based heavily on future performance expectations, so while past metrics are important, any final rating will incorporate DBRS's opinion on future metrics, a subjective but critical consideration.
- It is also not uncommon for a company's key ratios to move in and out of the ranges noted in the ratio matrix above, particularly for cyclical industries. In the application of this matrix, however, DBRS is typically focusing on multi-year ratio averages.
- Notwithstanding these potential limitations, the key ratios are very useful in providing a good starting point in assessing a company's financial risk.
- It is important to note that actual financial ratios for an entity can and will be influenced by both accounting and accounting choices. In Canada, this will include the shift to International Financial Reporting Standards (IFRS). DBRS acknowledges that IFRS and other accounting choices will have an impact on the financial metrics of the companies that it covers. The financial risk factors include ratios based on data from company financial statements that are based on Canadian Generally Accepted Accounting Principles (GAAP) and U.S. GAAP, for the most part. When company financial statements are based on GAAP in other countries, including IFRS, the ratios and ranges may need to be redefined.
- Recognizing that the metrics in the table above do not represent the entire universe of considerations that DBRS examines when evaluating the financial risk profile of a company, the following provides a general overview that encompasses a broader range of metrics and considerations that could be meaningful in some cases.



---

## Overall Considerations in Evaluating a Company's Financial Risk Profile

---

In addition to the information already provided with respect to key financial metrics, the following financial considerations and ratios are typically part of the analysis for the North American energy utilities (electric and natural gas) industry. As it is not possible to completely separate business and financial risks, note that many of the following ratios will relate to both areas.

### EARNINGS

- DBRS earnings analysis focuses on core earnings or earnings before non-recurring items and in doing so considers issues such as the sources, mix and quality of revenue; the volatility or stability of revenue; the underlying cost base (e.g., the company is a low-cost producer); optimal product pricing; and potential growth opportunities. Accordingly, earnings as presented in the financial statements are often adjusted for non-recurring items or items not considered part of ongoing operations.
- DBRS generally reviews company budgets and forecasts for future periods. Segmented breakdowns by division are also typically part of DBRS analysis. Notwithstanding the focus on core earnings, note that actual net earnings is also a consideration in our analysis given the direct impact that this has on the capital structure.

#### *Typical Earnings Ratios*

- EBIT or operating margin.
- Profit margin.
- Return on common equity.

### CASH FLOW AND COVERAGE

- DBRS cash flow analysis focuses on the core ability of the company to generate cash flow to service current debt obligations and other cash requirements as well as on the future direction of cash flow. From a credit analysis perspective, insufficient cash sources can create financial flexibility problems, even though net income metrics may be favourable.
- DBRS evaluates the sustainability and quality of a company's core cash flow by focusing on cash flow from operations and free cash flow before and after working capital changes. Using core or normalized earnings as a base, DBRS adjusts cash flow from operations for as many non-recurring items as relevant. As with earnings, the impact that non-core factors have on cash flow may also be an important reality.
- In terms of outlook, DBRS focuses on the projected direction of free cash flow, the liquidity and coverage ratios and the company's ability to internally versus externally fund debt reduction, future capital expenditures and dividend and/or stock repurchase programs, as applicable.

#### *Typical Cash Flow and Coverage Ratios*

- EBIT interest coverage (times).
- EBITDA interest coverage (times).
- Cash flow-to-total debt.
- Cash flow-to-capital expenditures.
- Dividend/distribution payout ratio.



## BALANCE-SHEET AND FINANCIAL FLEXIBILITY CONSIDERATIONS

- As part of determining the overall financial risk profile, DBRS evaluates various other factors to measure the strength and quality of the company's assets and its financial flexibility. From a balance-sheet perspective, DBRS focuses on the quality and composition of assets, including goodwill and other intangibles; off-balance-sheet risk; and capital considerations such as the quality of capital, appropriateness of leverage to asset quality and the ability to raise new capital.
- DBRS also reviews the company's strategies for growth, including capital expenditures and plans for maintenance or expansion, and the expected source of funding for these requirements, including bank lines and related covenants. Where the numbers are considered significant and the adjustments would meaningfully affect the credit analysis, DBRS adjusts certain ratios for items such as operating leases, derivatives, securitizations, hybrid issues, off-balance-sheet liabilities and various other accounting issues.

### *Typical Balance-Sheet Ratios*

- Current ratio.
- Total debt in capital structure.

---

## Stage 3: Rating the Security

---

With respect to Stage 3, the following comments describe how the issuer rating is used to determine ratings on individual securities:

- DBRS uses a hierarchy in rating long-term debt that affects issuers that have classes of debt that do not rank equally. In most cases, lower-ranking classes would receive a lower DBRS rating. For more detail on this subject, please refer to DBRS rating policy entitled "[Underlying Principles](#)."
- In some cases, issued debt is secured by collateral. This is more typical in the non-investment-grade spectrum. For more detail on this subject, please refer to [DBRS Rating Methodology for Leveraged Finance](#).
- The existence of holding companies can have a meaningful impact on individual security ratings. For more detail on this subject, please refer to the criteria [Rating Parent/Holding Companies and Their Subsidiaries](#).



---

## Appendix

---

### INDUSTRY BUSINESS RISK RATINGS

- DBRS uses the concept of business risk ratings (BRRs) as a tool in assessing the business strength of both industries and individual companies within many methodologies across the corporate finance area. (DBRS does not typically use this approach for most financial, government and public finance sectors, where the industry is more challenging to define and this approach is not as useful.)
- The BRR is assessed independently of financial risk, although in some cases there are subtle but important links. As an example, the very low business risk profile of many regulated utilities has historically allowed this sector to operate with debt levels that would not be acceptable for most other industry sectors. Given this reality, it is difficult to consider the utility industry's BRR without acknowledging to some degree that the industry operates with sizable debt levels. This type of relationship exists with many industries, although typically to a much lesser degree.
- When a BRR is applied to an industry, there is an acknowledgment that this is a general assessment and there may in fact be a wide disbursement in the business strength of individual entities within the industry. Nonetheless, this assessment is beneficial to enabling DBRS to clearly delineate our industry opinion and is a useful tool when comparing different industries. An industry BRR is defined as being representative of those entities that the market would consider as "established," meaning that the group of companies being considered would have at least reasonable critical mass and track records. As such, the BRR for an industry does not consider very small players, start-up operations or entities that have unusual strengths or weaknesses relative to the base industry.
- DBRS methodologies note whether they apply to global industries or more specific countries or regions. When analyzing individual credits, DBRS considers the degree to which regional considerations may differ from the geographic area applicable within the industry methodology. Many entities have business units that transcend industries and in these cases, more than one BRR would be considered, including the possible benefits or challenges that may exist when all businesses are analyzed as part of a combined group.
- The BRR is a tool that provides additional clarity regarding the business risk of the industry overall, but it should be viewed as just one aspect in the complex analysis of setting ratings and should by no means be seen as either a floor or ceiling for issuers within a given industry. Although DBRS does not anticipate volatility in an industry's BRR, changes are possible over time if there are meaningful structural developments in the industry. When such a change does occur, DBRS will make this clear and note any impact on related individual ratings within the industry as applicable.
- DBRS assesses five areas to establish the overall BRR for an industry. Although there is an overlap in some instances (to some degree, in the long term, all five factors tend to relate to profitability and stability), DBRS has found that considering these five measures in a separate fashion is a useful way of approaching its analysis. In all cases, DBRS uses historic performance and our experience to determine an opinion on the future, which is the primary focus.

#### *Industry Profitability and Cash Flow*

- When ratios such as return on equity, return on capital and a variety of cash flow metrics are considered, some industries are simply more profitable than others. While standard economics would suggest a reversion to the mean through new competitors, this often occurs at a very slow pace over a long time horizon and in some cases may not occur at all because of barriers to entry.
- The benefits from above-average profits and/or cash flow are substantial and include internal capital growth, easier access to external capital and an additional buffer to unexpected adversity from both liquidity and capital perspectives.
- Some industries and their participants have challenges or strengths in areas such as research and development (R&D), brand recognition, marketing, distribution, cost levels and a potentially wide variety of other tangibles and intangibles that affect their ability in the area of profitability.



### *Industry Competitive Landscape*

- The competitive landscape provides information regarding future profitability for the industry and thus somewhat crosses over into the profitability and cash flow assessment, but competition is deemed worthy of separate consideration because of its critical nature.
- Participants in industries that lack discipline, produce commodity-like products or services, have low barriers to entry and exhibit ongoing pricing war strategies generally have difficulty attaining high profitability levels in the longer term. Certain industries benefit from a monopoly or oligopoly situation, which may relate to regulation.

### *Industry Stability*

- This factor relates primarily to the degree of stability in cash flow and earnings, measuring the degree to which the industry and its participants are affected by economic or industry cycles. Stability is considered critical as industries with high peaks and troughs have to deal with higher risk at the bottom of a cycle. As such, to some degree, industries with lower but stable profitability are considered more highly than industries with higher average profitability that is more cyclical.
- Some of the key factors in considering stability include the nature of the cost structure (fixed or variable), diversification that provides counter-cyclical and the degree to which the industry interrelates with the overall economy. Depending on the industry, economic factors could include inflation or deflation, supply and demand, interest rates, currency swings and future demographics.

### *Industry Regulation*

- Where applicable, regulation can provide support through stability and a barrier to entry, but it can also cause challenges and change the risk profile of an industry and its participants in a negative way, including the reality of additional costs and complications in enacting new strategies or other changes.
- As part of its analysis of regulation, DBRS also considers the likelihood of deregulation for a regulated industry, noting the many examples where this transition has proven to be a major challenge in the past.

### *Other Inherent Industry Considerations*

- Each industry has its own set of unique potential risks that, even if managed well, cannot be totally eliminated. Specific risks, the ability to manage them and the range of potential outcomes vary industry by industry. Two of the most common risks are changing technology and operational risks.
- Some of the other more common risks are in the areas of legal, product tampering, weather, natural disasters, labour relations, currency, energy prices, emerging markets and pensions.



## INDUSTRY BUSINESS RISK RATING DEFINITIONS

DBRS specifies the BRR for an industry in terms of our **Long-Term Obligations** rating scale. When discussing industry BRRs for an industry, DBRS typically provides either one specific rating or a limited range (such as BBB (high)/BBB). Using a range recognizes the fact that, by their nature, industry BRRs are less precise than a specific corporate or security rating as they represent an overall industry. In addition to relating to the industry level, these definitions also apply to the business risk of individual companies, which will fall more often in the very high and low categories (AA/AAA and B) than would be the case for an entire industry.

---

### Industry Business Risk Ratings (BRRs)

---

Rating	Business Strength	Comment
AA/AAA	Exceptional	An industry BRR of AA/AAA is considered unusually strong, with no meaningful weakness in any individual area. It may include pure monopolies that are deemed essential (the primary case being regulated utilities, where the risk of deregulation is believed to be very low). Common attributes include product differentiation, high barriers to entry and meaningful cost advantages over other industries or entities. These and other strengths provide exceptional stability and high profitability. It would be quite rare for an industry to have a BRR in this category.
A	Superior	Industry BRRs at the "A" level are considered well above average in terms of stability and profitability and typically have some barriers to entry related to capital, technology or scale. Industries that have, by their nature, inherent challenges in terms of cyclicalities, a high degree of competition and technology risks would be unlikely to attain this rating category.
BBB	Adequate	Industry BRRs at the BBB level include many cyclical industries where other positive considerations are somewhat offset by challenges related to areas such as commodity products, labour issues, low barriers to entry, high fixed costs and exposure to energy costs. This rating category is considered average and many industries fall within it, with key considerations such as overall profitability and stability typically considered as neither above or below average.
BB	Weak	An industry at the BB level has some meaningful challenges. In addition to high cyclicalities, challenges could include the existence of high technology or other risks. Long-standing industries that may have lost their key strengths through factors such as new competition, obsolescence or the inability to meet changing purchaser demands may fit here. The culmination of such factors results in an industry that does not generally score well in terms of stability and profitability. For an entire industry, this is typically the lowest BRR level.
B	Poor	While not common, there are cases where an industry can have a BRR of B. Such industries would typically be characterized by below-average strength in all or virtually all major areas.



## INTERRELATIONSHIP BETWEEN FINANCIAL AND BUSINESS RISK

Having in mind the prior discussion on the typical importance that DBRS places on certain financial metrics and business strengths for the North American energy utilities (electric and natural gas) industry, we provide some guiding principles pertaining to the application of DBRS methodologies, the first one being that, in most cases, an entity's business risk will carry more weight in the final rating than its financial risk.

Based on this underlying concept, we provide the additional guidance for individual companies with varying business risks:

- **For an Entity with a Business Risk of AA (Exceptional):** A company with a business risk of AA will almost always be able to obtain an investment-grade issuer rating. When financial metrics are in the BBB range, an entity with a business risk of AA would typically be able to attain an "A"-range issuer rating.
- **For an Entity with a Business Risk of "A" (Superior):** Unless financial strength fails to exceed the B range, superior business strength will typically allow the final issuer rating to be investment grade. Very conservative financial risk may in some cases allow the final issuer rating to be within the AA range, but this should not be considered the norm.
- **For an Entity with a Business Risk of BBB (Adequate):** At this average level of business risk, the level of financial risk typically has the ability to result in a final issuer rating from as high as "A" to as low as B.
- **For an Entity with a Business Risk of BB (Weak):** At this weak level of business risk, conservative financial risk can, in some cases, take the final issuer rating into the BBB investment-grade range.
- **For an Entity with a Business Risk of B (Poor):** It is not typically possible for a company with a business risk of B to achieve a final investment-grade issuer rating.

## DEFINITION OF ISSUER RATING

- DBRS Corporate rating analysis begins with an evaluation of the fundamental creditworthiness of the issuer, which is reflected in an "issuer rating". Issuer ratings address the overall credit strength of the issuer. Unlike ratings on individual securities or classes of securities, issuer ratings are based on the entity itself and do not include consideration for security or ranking. Ratings that apply to actual securities (secured or unsecured) may be higher, lower or equal to the issuer rating for a given entity.
- Given the lack of impact from security or ranking considerations, issuer ratings generally provide an opinion of default risk for all industry sectors. As such, issuer ratings in the banking sector relate to the final credit opinion on a bank that incorporates both the intrinsic rating and support considerations, if any.
- DBRS typically assigns issuer ratings on a long-term basis using its **Long Term Obligations** Rating Scale; however, on occasion, DBRS may assign a "short-term issuer rating" using its **Commercial Paper and Short Term Debt** Rating Scale to reflect the issuer's overall creditworthiness over a short-term time horizon.

## SHORT-TERM AND LONG-TERM RATINGS

- For a discussion on the relationship between short- and long-term ratings and more detail on liquidity factors, please refer to the DBRS policy entitled "**Short-Term and Long-Term Rating Relationships**" and the criteria *DBRS Commercial Paper Liquidity Support Criteria for Corporate Non-Bank Issuers*.

Copyright © 2011, DBRS Limited, DBRS, Inc. and DBRS Ratings Limited (collectively, DBRS). All rights reserved. The information upon which DBRS ratings and reports are based is obtained by DBRS from sources DBRS believes to be accurate and reliable. DBRS does not audit the information it receives in connection with the rating process, and it does not and cannot independently verify that information in every instance. The extent of any factual investigation or independent verification depends on facts and circumstances. DBRS ratings, reports and any other information provided by DBRS are provided "as is" and without representation or warranty of any kind. DBRS hereby disclaims any representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability, fitness for any particular purpose or non-infringement of any of such information. In no event shall DBRS or its directors, officers, employees, independent contractors, agents and representatives (collectively, DBRS Representatives) be liable (1) for any inaccuracy, delay, loss of data, interruption in service, error or omission or for any damages resulting therefrom, or (2) for any direct, indirect, incidental, special, compensatory or consequential damages arising from any use of ratings and rating reports or arising from any error (negligent or otherwise) or other circumstance or contingency within or outside the control of DBRS or any DBRS Representative, in connection with or related to obtaining, collecting, compiling, analyzing, interpreting, communicating, publishing or delivering any such information. Ratings and other opinions issued by DBRS are, and must be construed solely as, statements of opinion and not statements of fact as to credit worthiness or recommendations to purchase, sell or hold any securities. A report providing a DBRS rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. DBRS receives compensation for its rating activities from issuers, insurers, guarantors and/or underwriters of debt securities for assigning ratings and from subscribers to its website. DBRS is not responsible for the content or operation of third party websites accessed through hypertext or other computer links and DBRS shall have no liability to any person or entity for the use of such third party websites. This publication may not be reproduced, retransmitted or distributed in any form without the prior written consent of DBRS. ALL DBRS RATINGS ARE SUBJECT TO DISCLAIMERS AND CERTAIN LIMITATIONS. PLEASE READ THESE DISCLAIMERS AND LIMITATIONS AT <http://www.dbrs.com/about/disclaimer>. ADDITIONAL INFORMATION REGARDING DBRS RATINGS, INCLUDING DEFINITIONS, POLICIES AND METHODOLOGIES, ARE AVAILABLE ON <http://www.dbrs.com>.



*Insight beyond the rating.*

[www.dbrs.com](http://www.dbrs.com)

---

**Corporate Headquarters**

DBRS Tower  
181 University Avenue  
Suite 700  
Toronto, ON M5H 3M7  
TEL +1 416 593 5577