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INVESTORS SERVICE

Consolidation, Holding Companies and the Regulatory Compact

SURFA Financial Forum

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Agenda

1. Industry Trends
2. Consolidation Themes
3. Ratings Approach to Consolidation
4. Consolidation's Effect on Ratings

1 Industry Trends

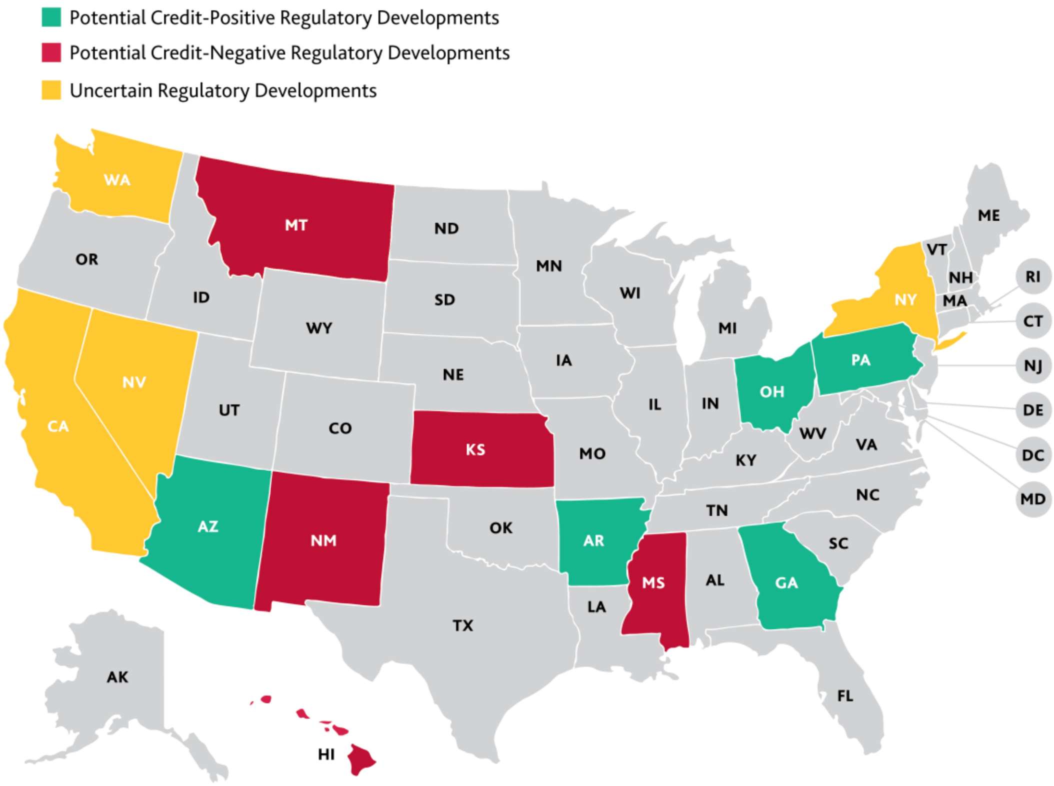
Regulated Utility Overview

2017 Key Themes

- Regulatory support still strong, but some signs of regulatory challenges
- Tax Reform poses risks, but regulatory response is key
- Strategic actions still on the table
  - M&A could continue despite tax uncertainties
    - Fueled mainly by Canadian interest in the US
- Transition to a cleaner and smarter infrastructure well underway
  - De-carbonization not impacted by Federal politics; although policy can influence timing
  - Renewables continue to progress amidst falling costs

Regulatory Supportiveness

» Regulatory support is still strong, for the most part
  – However, we do see instances of challenged relationships
    » Might these instances shift into a trend?

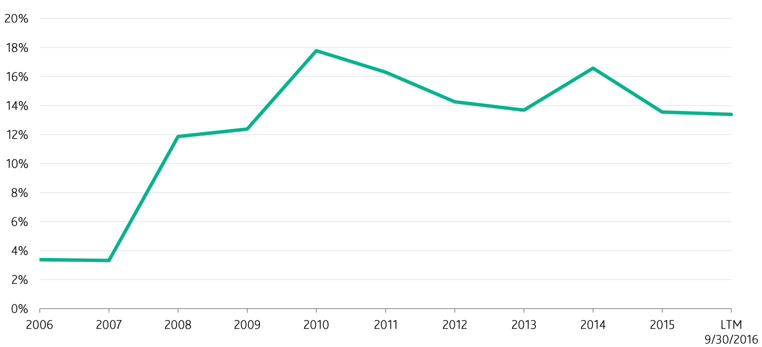


Federal Tax Reform Poses Risks

» Tax rate reduction is the biggest threat to utilities

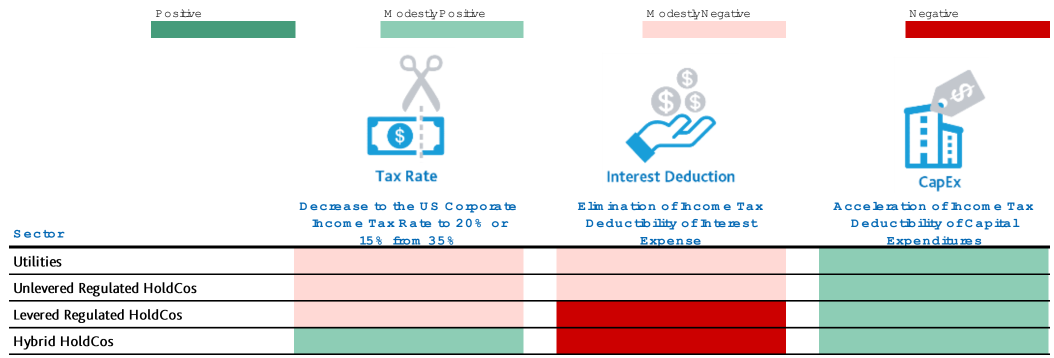
– Very few companies are paying cash taxes, resulting in mounting DTL's

HoldCo deferred tax as a percent of FFO



Source: Moody's Investors Service

Cash consequences vary across sector and type of reform



Source: Moody's Investors Service

» Interest deductibility is of most concern to levered holding companies

» Expensing of capex would have a modestly positive credit impact

» Regulatory response is critical

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Consolidation Themes

Themes of Strategic Alternatives

- Electric and gas utility convergence
  - Large electric bellwethers acquiring smaller LDCs
- Diversification into unregulated midstream opportunities
  - Long-haul natural gas pipeline investments
  - Intermediate-pipes
  - Gathering infrastructure in order to get gas to market
- “Canadian Invasion”
  - Large, diversified Canadian energy companies seeking footholds in the US

Holding Company Activity

- Strategy to provide earnings growth and diversification opportunities not found in power sector
- Most utility transactions have featured high acquisition multiples and significant leverage
  - View of "debt capacity" at the parent level
    - Increased financial risk at parent
    - Declining consolidated financial metrics
- US M&A may be taking a breather
  - Most large US holding companies are taking time to digest and integrate acquisition partners
  - Bid – Ask spread may be wide
    - LDC P/E multiples have inflated
  - Potential for US tax reform brings uncertainty
  - Next round could be more merger-of-equal's (usually financed with equity)
- Canadian interest will continue

Canadian Interest in the US

- Rationale for Canadian acquirers
  - Growth: stronger US returns and transactions that are accretive to EPS
  - Diversification
  - Limited Canadian acquisition targets
  - Low cost financing
- Canadian acquirers are a bit different
  - Often fully retain management teams
    - Not looking for the same synergies as US acquirers
  - FX risk
  - Tax arbitrage opportunities
- More large Canadian utilities have announced their interest in making acquisitions

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Rating Approach to Consolidation

General M&A Observations

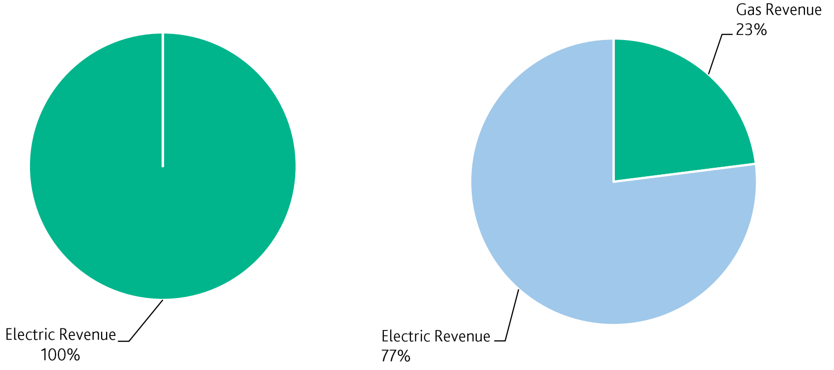
- Recent trend has been mostly negative for holding companies
- A majority of the utilities are unaffected
  - Moody’s “bottom-up” ratings approach
    - Utilities are rated on a standalone basis, typically
  - Becoming part of a larger, more diverse corporate umbrella
- Negative impact to utilities can occur
  - Highly levered transaction
    - > 30% holdco to consolidated debt at the immediate holding company
  - Single utility to service acquisition debt
- Ring-fencing type provisions can help provided additional credit support for the utility

Strategic Rationale is Generally Sound

- The convergence trend and consolidation is credit positive
  - Increased size, scale and scope
    - GXP / WR neighboring and complimentary
  - Diversification is viewed as a defensive maneuver
    - Low organic growth in electric demand
      - Gas as a platform for growth
    - Threat of distributed generation
    - Concentration of regulatory exposure
- Southern's acquisition of AGL is meaningful
  - Entirely different line of business
  - Size of AGL is material
  - Some service territory outside of southeast

Southern will benefit the most from business and revenue diversification

Southern's pre-acquisition revenue mix (left) versus post-acquisition revenue expectations (right).



Sources: Southern Co. and AGL Resources

Increasing Leverage Undermines Qualitative Benefits

- High equity valuations are creating high acquisition multiples
  - >20% stock price premiums and >10x EBITDA multiples are common
- Financed mostly with debt, issued at the holding company
  - Holdco debt as a percentage of consolidated debt is increasing
  - Consolidated financial metrics are decreasing
- Resulting in negative ratings actions
  - Potential for wider notching between parent and subsidiaries
  - Utility ratings could be constrained or even downgraded
- HoldCo debt could pose problems down the road
  - Trend is evidencing management's increased financial risk tolerance
  - Use of "debt capacity" now could cause further credit deterioration in the face of:
    - Increasing interest rates and refinancing risk
    - Loss of interest deductibility due to tax reform

Utility Financial Pressure is Key

» More likely to see utility downgrades when added debt service burden is concentrated to one, or few, utilities

Illustrative examples of acquired company's ability to service acquisition debt with dividends

Company/Target	Current Rating	Target Rate Base	Assumed Debt	Acquisition Debt	Total Debt	Total Debt / Target Rate Base	Weighted-Avg. Coupon Rate of Acq. Debt	3 Yr Avg Dividend / Acquisition Debt Interest Expense	3 Yr Avg Net Income / Acquisition Debt Interest Expense
ITC	Baa2	$ 5,300	$ 4,400	$ 4,400	$ 4,400	83%	2.82%	77%	193%
Piedmont	A2	$ 2,300	$ 2,000	$ 3,700	$ 5,700	248%	2.92%	91%	128%
AGL	WR	$ 5,500	$ 4,000	$ 8,000	$ 12,000	218%	3.16%	99%	149%
Empire	Baa1	$ 1,700	$ 855	$ 855	$ 855	50%	5.00%	104%	146%
Westar	Baa1	$ 6,300	$ 3,300	$ 4,400	$ 7,700	122%	3.68%	108%	185%
Pepco	Baa2	$ 8,000	$ 6,000	$ 4,200	$ 10,200	128%	4.14%	157%	68%
Cleco Corp	Baa3	$ 2,829	$ 1,300	$ 1,350	$ 2,650	94%	4.23%	163%	262%
TECO	Baa2	$ 6,100	$ 3,800	$ 3,250	$ 7,050	116%	3.60%	172%	143%
Cleco Power	A3	$ 2,829	$ 1,300	$ 1,350	$ 2,650	94%	4.23%	207%	260%
Tampa Electric	A3	$ 6,100	$ 3,800	$ 3,250	$ 7,050	116%	3.60%	215%	216%
Integrys	A3	$ 4,200	$ 3,300	$ 3,300	$ 3,300	79%	2.71%	239%	343%
Questar Corp.	WR	$ 2,650	$ 1,400	$ 2,200	$ 3,600	136%	2.03%	303%	446%

Source: Moody's Investors Service

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Consolidation’s Effect on Ratings

M&A as Positive for the Acquired Company

Recent examples of M&A driving positive ratings actions for the target company

	Date	Rating Pre	Rating Post	Debt Pre (YE 2015)	Debt Post (YE 2016)	CFO/Debt Pre (YE 2015)	CFO/Debt Post (YE 2016)
Exelon	Mar-16	Baa2	Baa2	$ 34,695	$ 43,595	23%	17%
Pepco		Baa3	Baa2	$ 7,143	$ 6,758	14%	17%
Black Hills	Feb-16	Baa1	Baa2	$ 2,049	$ 3,432	18%	12%
SourceGas Holdings		Baa2	Baa1/WR	$ 989	-	9%	-

Source: Moody's Investors Service

M&A as Neutral for the Acquired Company

Recent examples of M&A resulting in affirmed ratings for the target company

	Date	Rating Pre	Rating Post	Debt Pre	Debt Post	CFO/Debt Pre LTM 2015	CFO/Debt Post LTM 2016
Great Plains	2Q 2017	Baa2	Baa3	$ 4,729	$ 4,855	16%	18%
Westar		Baa1	Baa1	$ 4,033	$ 4,517	22%	21%
Fortis	Feb-17	Baa3	Baa3	$ 9,837	$ 18,089	12%	8%
ITC		Baa2	Baa2	$ 4,509	$ 4,684	12%	15%
Algonquin	Jan-17	NR	NR	$ 1,639	$ 4,441	12%	9%
Empire		Baa1	-	$ 949	$ 927	21%	23%
Duke	Oct-16	A3	Baa1	$ 41,536	$ 49,601	16%	13%
Piedmont		A2	A2	$ 1,960	$ 2,030	18%	21%
Southern	Jul-16	Baa1	Baa2	$ 30,644	$ 48,956	21%	9%
AGL		Baa1	Baa1	$ 5,252	$ 6,858	21%	11%
WEC	Jun-15	A3	Baa1	$ 5,177	$ 10,494	24%	13%
Integrys		A3	A3	$ 3,500	$ 3,787	22%	16%

Source: Moody's Investors Service

M&A as Negative for the Acquired Company

Some M&A results in ratings downgrades for the target

	Date	Rating Pre	Rating Post	Debt Pre	Debt Post	CFO/Debt Pre	CFO/Debt Post
Altagas	Pending	NR	NR	-	-	-	-
WGL		A3, STA	A3, NEG	$ 2,069	-	21%	-
Washington Gas Light		A1, STA	A1, NEG	$ 1,344	-	22%	-
Dominon	Sep-16	Baa2	Baa2	$ 29,677	$ 36,454	16%	11%
Questar Corp.		P-1	P-2/WR	$ 1,833	-	29%	-
Questar Gas		A2	A2	$ 828	$ 879	24%	18%
Emera	Jul-16	NR	Baa3	$ 3,358	$ 12,387	16%	6%
TECO		Baa1	Baa2	$ 4,238	$ 4,270	17%	14%
Tampa Electric		A2	A3	$ 2,446	$ 4,271	28%	25%
Macquarie	Mar-16	-	-	-	-	-	-
Cleco Corp		Baa1	Baa3	$ 3,579	$ 4,042	28%	6%
Cleco Power		A3	A3	$ 1,393	$ 1,398	26%	16%
Macquarie	Feb-09	-	-	-	-	-	-
Puget Energy		Ba1	Ba2	$ 3,268	$ 5,327	17%	10%
Puget Sound Energy		Baa2/P-1	Baa2/P-2	$ 3,145	$ 3,770	18%	17%
Macquarie	May-07	-	-	-	-	-	-
Duquesne Light Holdings		Baa3	Ba1	$ 1,356	$ 1,882	11%	7%
Duquesne Light Co.		Baa2	Baa2	$ 872	$ 462	15%	38%

Source: Moody's Investors Service

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Appendix

Moody's Global Presence

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Facts & Figures: 2015 - 2016

$67+ trillion of Total Rated Debt

4,800 Rated Non-Financial Corporates

3,900 Rated Financial Institutions

133 Rated Sovereigns

45 Rated Supranational Institutions

19,600 Rated Public Finance Issuers

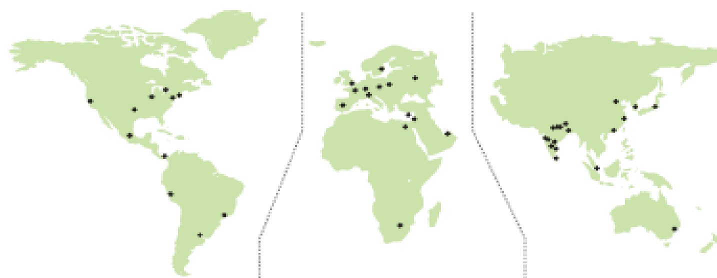
11,800 Rated Structured Deals

1,100 Rated Infrastructure & Project Finance Issuers

230 Rating Methodologies

10,800 Moody's Corporation employees

30* Countries



Americas	EMEA	APAC
5,900 Rated Companies	**2,800** Rated Companies	**1,100** Rated Companies
$31 trillion Total Debt Rated	**$21 trillion** Total Debt Rated	**$15 trillion** Total Debt Rated
25,700 Research Documents	**14,400** Research Documents	**3,900** Research Documents

MOODY'S INVESTORS SERVICE OFFICES

Americas	EMEA		APAC	
United States	Cyprus	Italy	Australia	Nepal**
Canada	Czech Rep.	Poland	China**	Singapore
Argentina	DIFC	Russia	Hong Kong	Sri Lanka**
Brazil	Egypt**	South Africa	India**	
Mexico	France	Spain	Japan	
Peru**	Germany	Sweden	Korea**	
Panama**	Israel**	UK		

EVENTS

200+ Conferences

200+ Roundtables

250+ Teleconferences

100+ 2nd Party Conferences

30,800 Global Events Participants

7,000+ Global Events

RESEARCH

44,000 Research Publications

- **40,000** Company Research
- **4,000** Industry Research

» 1.3+ million research views by top 10 global investment banks and asset managers

RESEARCH PUBLICATIONS BY SEGMENT

7,900	Non-Financial Corporates
6,600	Financial Institutions
1,700	Sovereign & Sub-Sovereign
7,000	U.S. Public Finance
18,200	Structured Finance
2,100	Infrastructure & Project Finance
500	Cross Sector

* Including affiliates of Moody's Investors Service. **MIS affiliate location.

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Most Influential Credit Rating Agency: 2013–2016

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Credit ratings are forward-looking opinions

We communicate our analysis and views about credit risk

- Moody's credit ratings are **forward-looking opinions** of the relative credit risk of financial obligations
- **Credit Risk:** the willingness and the ability of an issuer to pay its debt in a timely manner (in accordance to its contractual promise) and in full
- Moody's rating system provides a **rank ordering of relative creditworthiness**:
- 6 broad categories; 21 refined categories
- Short term ratings
- Further refined by Watch-lists and Outlooks

LONG TERM	SHORT TERM
Aaa	
Aa1 Aa2 Aa3	Prime-1
A1 A2 A3	Prime-2
Baa1 Baa2 Baa3	Prime-3
Ba1 Ba2 Ba3	
B1 B2 B3	Not Prime
Caa1 Caa2 Caa3 Ca C	

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