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# Consolidation, Holding Companies and the Regulatory Compact

SURFA Financial Forum

# Agenda

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

# 1

## Industry Trends

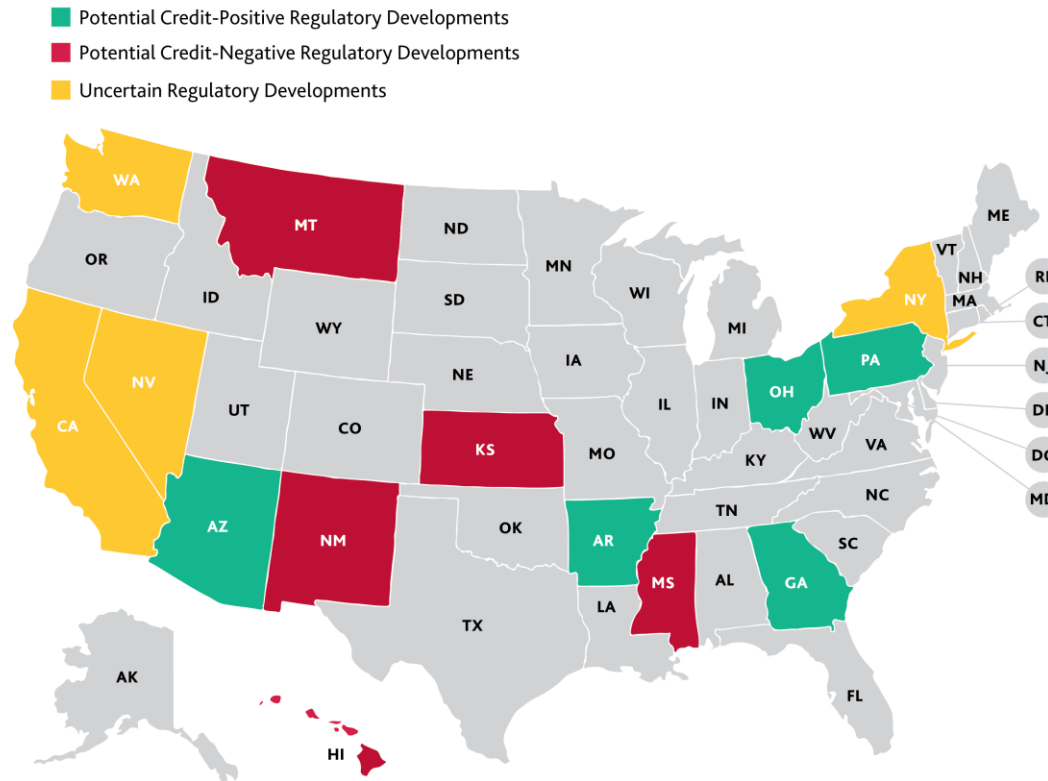
# Regulated Utility Overview

## 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

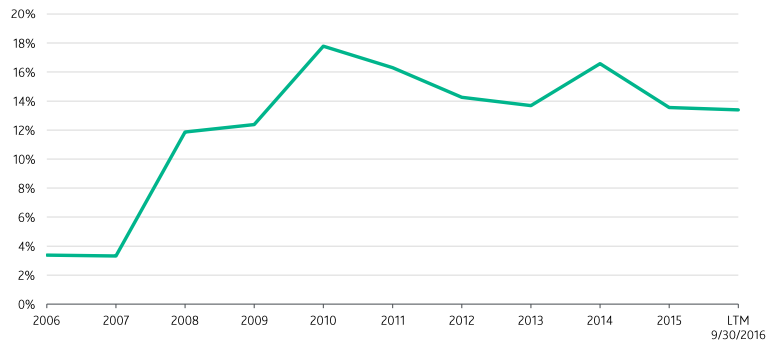
- » Regulatory support is still strong, for the most part
  - However, we do see instances of challenged relationships
    - » Might these instances shift into a trend?



# Federal Tax Reform Poses Risks

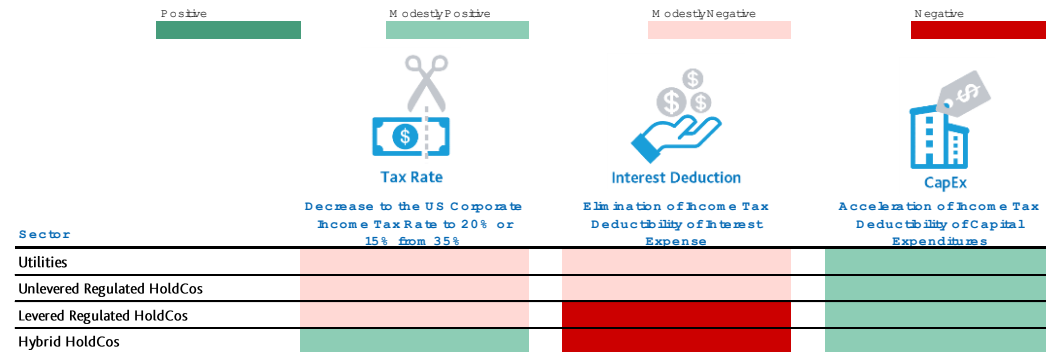
- » Tax rate reduction is the biggest threat to utilities
  - Very few companies are paying cash taxes, resulting in mounting DTL's

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

# 2

## 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

# 3

## Rating Approach to Consolidation

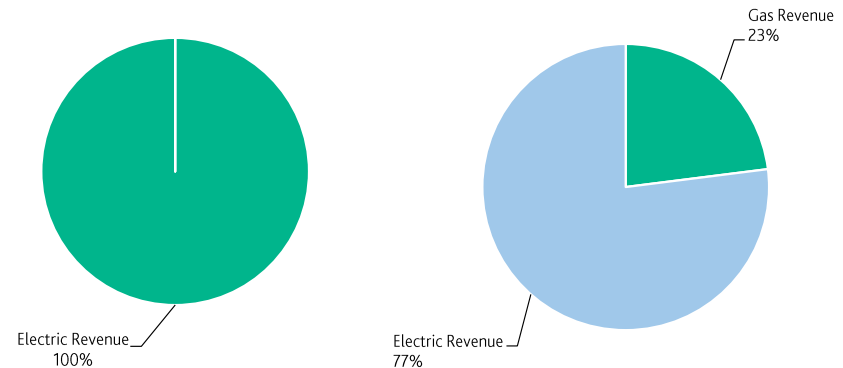
# General M&A Observations

- » 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%
Integrus	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

# 4

## 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)
<b>Exelon</b>		Baa2	Baa2	\$ 34,695	\$ 43,595	23%	17%
<b>Pepco</b>	Mar-16	Baa3	Baa2	\$ 7,143	\$ 6,758	14%	17%
<b>Black Hills</b>		Baa1	Baa2	\$ 2,049	\$ 3,432	18%	12%
<b>SourceGas Holdings</b>	Feb-16	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
<b>Great Plains</b>	2Q 2017	Baa2	Baa3	\$ 4,729	\$ 4,855	16%	18%
<b>Westar</b>		Baa1	Baa1	\$ 4,033	\$ 4,517	22%	21%
<b>Fortis</b>	Feb- 17	Baa3	Baa3	\$ 9,837	\$ 18,089	12%	8%
<b>ITC</b>		Baa2	Baa2	\$ 4,509	\$ 4,684	12%	15%
<b>Algonquin</b>	Jan- 17	NR	NR	\$ 1,639	\$ 4,441	12%	9%
<b>Empire</b>		Baa1	-	\$ 949	\$ 927	21%	23%
<b>Duke</b>	Oct- 16	A3	Baa1	\$ 41,536	\$ 49,601	16%	13%
<b>Piedmont</b>		A2	A2	\$ 1,960	\$ 2,030	18%	21%
<b>Southern</b>	Jul- 16	Baa1	Baa2	\$ 30,644	\$ 48,956	21%	9%
<b>AGL</b>		Baa1	Baa1	\$ 5,252	\$ 6,858	21%	11%
<b>WEC</b>	Jun- 15	A3	Baa1	\$ 5,177	\$ 10,494	24%	13%
<b>Integrys</b>		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
<b>Altagas</b>		NR	NR	-	-	-	-
<b>WGL</b>	Pending	A3, STA	A3, NEG	\$ 2,069	-	21%	-
<b>Washington Gas Light</b>		A1, STA	A1, NEG	\$ 1,344	-	22%	-
<b>Dominion</b>		Baa2	Baa2	\$ 29,677	\$ 36,454	16%	11%
<b>Questar Corp.</b>	Sep- 16	P- 1	P- 2/WR	\$ 1,833	-	29%	-
<b>Questar Gas</b>		A2	A2	\$ 828	\$ 879	24%	18%
<b>Emera</b>		NR	Baa3	\$ 3,358	\$ 12,387	16%	6%
<b>TECO</b>	Jul- 16	Baa1	Baa2	\$ 4,238	\$ 4,270	17%	14%
<b>Tampa Electric</b>		A2	A3	\$ 2,446	\$ 4,271	28%	25%
<b>Macquarie</b>		-	-	-	-	-	-
<b>Cleco Corp</b>	Mar- 16	Baa1	Baa3	\$ 3,579	\$ 4,042	28%	6%
<b>Cleco Power</b>		A3	A3	\$ 1,393	\$ 1,398	26%	16%
<b>Macquarie</b>		-	-	-	-	-	-
<b>Puget Energy</b>	Feb- 09	Ba1	Ba2	\$ 3,268	\$ 5,327	17%	10%
<b>Puget Sound Energy</b>		Baa2/P- 1	Baa2/P- 2	\$ 3,145	\$ 3,770	18%	17%
<b>Macquarie</b>		-	-	-	-	-	-
<b>Duquesne Light Holdings</b>	May- 07	Baa3	Ba1	\$ 1,356	\$ 1,882	11%	7%
<b>Duquesne Light Co.</b>		Baa2	Baa2	\$ 872	\$ 462	15%	38%

Source: Moody's Investors Service

# 5

## Appendix

# Moody's Global Presence

MOODY'S  
INVESTORS SERVICE

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

**5,900**  
Rated Companies

**\$31 trillion**  
Total Debt Rated

**25,700**  
Research Documents

## EMEA

**2,800**  
Rated Companies

**\$21 trillion**  
Total Debt Rated

**14,400**  
Research Documents

## APAC

**1,100**  
Rated Companies

**\$15 trillion**  
Total Debt Rated

**3,900**  
Research Documents

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United States  
Canada  
Argentina  
Brazil  
Mexico  
Peru\*\*  
Panama\*\*

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Czech Rep.  
DIFC  
Egypt\*\*  
France  
Germany  
Israel\*\*  
Italy  
Poland  
Russia  
South Africa  
Spain  
Sweden  
UK

Australia  
China\*\*  
Hong Kong  
India\*\*  
Japan  
Korea\*\*  
Nepal\*\*  
Singapore  
Sri Lanka\*\*

## EVENTS

**200+**  
Conferences

**200+**  
Roundtables

**250+**  
Teleconferences

**100+**  
2<sup>nd</sup> 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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Australia's Rating Agency of the Year: 2014-2016



Best CLO Rating Agency: 2016



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Best Islamic Finance Rating Agency: 2015



Best Ratings Agency: 2016



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Best Islamic Rating Agency: 2015



Project Finance Firm of the Year (USA): 2015

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- » 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	Not Prime
Aa1	
Aa2	
Aa3	
A1	
A2	
A3	
Baa1	
Baa2	
Baa3	
Ba1	Prime-1
Ba2	
Ba3	
B1	
B2	
B3	
Caa1	
Caa2	
Caa3	
Ca	
C	

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