

U.S. Not-For-Profit Electric Utilities' Credit Quality Benefits From Factors That Insulate Them From Problems Plaguing Merchant Generators

Apr 09, 2018

[View Analyst Contact Information](#)

[Table of Contents](#)

[Rate This Article](#)

FirstEnergy Solutions Corp., a merchant energy subsidiary of FirstEnergy Corp., filed for Chapter 11 bankruptcy protection April 1, the latest in the sector that highlights the distinctions between merchant generation companies and public power and electric cooperative utilities.

In S&P Global Ratings' view, unlike their merchant generation counterparts, not-for-profit utilities have well-defined avenues for cost recovery and limited exposure to market stressors. These factors support the sound and stable ratings we have in the sector.

Key Takeaways

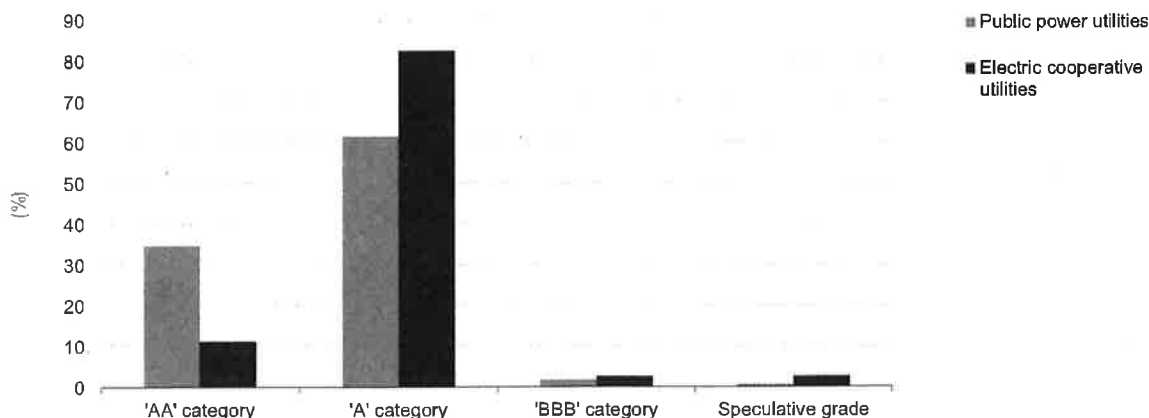
- Public power and electric cooperative utilities are distinguishable from merchant energy companies because of secure revenue streams.
- The not-for-profit utilities have limited reliance on competitive markets for revenues.
- The connection between not-for-profit utilities and their customers allows the utilities to recover generation investments, even when market resources might produce cheaper power.
- These elements underlie the strong and stable ratings we have on public power and electric cooperative utilities.

Not-For-Profit Utilities Have Limited Exposure To Market Forces

Ratings among public power and electric cooperative utilities benefit from their autonomous ratemaking authority, native load customers' strong obligation to support their utilities' costs, and modest-to-no surplus generation capacity. These limit their exposure to competitive wholesale markets. Contracts typically link wholesale public power and electric cooperative utilities to their customers, which supports predictable and reliable revenue streams. Retail, load-serving not-for-profit utilities consistently have exclusive service territories, which bind customers to their incumbent utilities and support predictability and stability. In our view, customer base dislocations are rare, as are utilities whose retail customers can choose alternative energy providers. Consequently, we expect that public power and electric cooperative utilities' financial performance, and our ratings on them (see chart), will by and large remain resilient in the face of difficult wholesale power markets.

[Download Chart Data](#)

Public Power And Electric Cooperative Utilities -- Ratings Distributions



Copyright © 2018 by Standard & Poor's Financial Services LLC. All rights reserved.

The Achilles' Heel Of Merchant Generators And Surplus Generation Owners

FirstEnergy Solutions' nuclear and coal units could not garner revenues sufficient to fully recover fixed costs in competitive markets, leading to its bankruptcy filing – which is only one of many for merchant generators. The list includes large and small companies whose fortunes sank with the relative competitiveness of their generation assets. Members of the club include Calpine Corp.; Dynegy Inc.; GenOn Energy Holdings Inc. (formerly Mirant Corp.); NRG Energy, Inc.; Texas Energy Future Holdings L.P.; AES Eastern Energy L.P.; Edison International's Midwest Generation LLC; PG&E National Energy Group Inc.; Exelon Corp.'s ExGen Texas Power Holdings LLC; and La Paloma Generating Co. LLC.

Recovering fixed generation investments can be an issue for merchant generators and more traditional utilities saddled with surplus generation. The main causes are recent years' low natural gas prices that are upending the relative economic profiles of many generating units. In addition, in some regions, renewable resources' output is flooding wholesale power markets with inexpensive power, disrupting the dispatch of conventional generation units. Stagnant electricity demand has compounded the problems generators face.

In practice, generation owners bid their units into the market at prices that will provide for the recovery of at least variable production costs. These units will only dispatch if the market is at or above their bid price. Fixed-cost recovery is another story. In many competitive markets, there are no guarantees of recovering these.

The last units to dispatch in a power market are those critical to meeting total market demand. These marginal generating units are typically the most expensive. The last entrant's production costs set the reference market price for all concurrent market participants. However, gas-fired and renewable generation resources have significantly reduced the marginal units' cost profile. Generally, a generation unit's owner will fully recover its fixed costs if the marginal generating units that follow it in the dispatch hierarchy have sufficiently high variable costs to cover both the fixed and variable costs of the preceding dispatching plants. Of late, the difference between the last entrant's costs and those of already producing units has either tightened or disappeared.

Strong Cost Recovery Prospects Benefit Not-For-Profit Utilities, And Those Lending To Them

Compared with the financial performance of many merchant generation companies, public power and electric cooperative utilities stand out for their stability. This is the case even in well-developed competitive markets like the Electric Reliability Council of Texas, where gas prices have idled or reduced the dispatch of a lot of the market's coal capacity, including that of many public power and electric cooperative utilities.

Not-for-profit utilities can look to their native load customers for fixed-cost recovery, even if their generation units cannot dispatch economically relative to other units in the market. This pathway to cost recovery supports their sound credit quality.

When public power and electric cooperative utilities can purchase market energy that provides more economical energy than self-production, they dial back the output of their own units. Against the backdrop of idle plants or low capacity factors is customers' ongoing obligations to support the utilities' recovery of investments in power plants operating below their capabilities (or not operating at all). That the customers' obligations do not abate is a key element of the sector's credit quality. When making economy energy purchases, the utilities provide bondholders and lenders with the protections of lower operating costs and their uncompromised ability to recover generation investments. At the same time, customers benefit from the lower variable costs embedded in their bills.

Surplus generation capacity can be an issue for load-serving not-for-profit utilities, giving them some of the same problems merchant generators face. When public power and electric cooperative utilities with excess generation capacity cannot sell their surplus output in the market to support the recovery of fixed costs, or sell at depressed prices, margins have eroded or have shifted fixed costs to native load customers, which drives rates up. Sometimes, we see both. In either case, weaker financial metrics or high rates that whittle ratemaking flexibility can negatively affect credit quality. However, because meaningful surplus generation capacity is rare among public power and electric cooperative utilities, we expect that the sector's financial performance and our ratings on them will largely stay resilient despite difficult wholesale power markets.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

Primary Credit Analyst: David N Bodek, New York (1) 212-438-7969;
david.bodek@spglobal.com
Secondary Contacts: Paul J Dyson, San Francisco (1) 415-371-5079;
paul.dyson@spglobal.com
Peter V Murphy, New York (1) 212-438-2065;
peter.murphy@spglobal.com
Jeffrey M Panger, New York (1) 212-438-2076;
jeff.panger@spglobal.com