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UTILITY POLICY RESEARCH

Proper Utility ROE Does Not Threaten Credit Ratings

The concern

Some claim that lower allowed returns on equity (ROE) will harm utility credit ratings. This concern does not stand up to scrutiny. A commission that calibrates ROE to the true cost of equity can fully protect credit quality with a modest, offsetting adjustment to the debt-equity mix, while delivering substantial ratepayer savings.

How rating agencies score utility credit

S&P and Moody's evaluate regulated utility creditworthiness using four financial metrics:

- Funds From Operations (FFO)/Debt
- Debt/Earnings Before Interest, Depreciation & Amortization (EBITDA)
- Earnings Before Interest (EBIT)/Interest
- Debt/Capitalization

The first three are variations on the same question: How much income or cash flow does the utility generate relative to its debt? The fourth is a balance sheet measure.

How lower allowed ROE could impact these metrics

A lower allowed ROE reduces utility income. Without corresponding adjustment in the utility's debt/equity ratio, this would negatively impact the first three metrics.

A simple fix

This impact can be fully offset through a small reduction in utility debt and corresponding increase in equity. This reduces the debt component of the first two ratios and the interest component of the third. As an added benefit, the reduction in debt actually drives *improvement* in the fourth metric, by reducing its numerator.

	10% ROE	7% ROE	7% ROE, lower debt
Capital structure			
Debt ($M)	$500	$500	$411
Equity ($M)	$500	$500	$589
Equity / Capitalization	50%	50%	58.9%
Credit metrics			
FFO / Debt	24.8%	21% ↓	27.4% ↑
Debt / EBITDA	3.2×	3.7× ↓	3.0× ↑
EBIT / Interest	3.8×	3.0× ↓	3.8× ✔
Debt / Capitalization	50.0%	50.0%	41.1% ↑
Financing costs			
Debt interest	$25.0	$25.0	$20.6
Equity return (pre-tax)	$50.0	$35.0	$41.2
Corporate income tax	$19.9	$13.9	$16.4
Total cost of capital	$94.9	$73.9	$78.2
Ratepayer savings	-	$21.0	$16.7

Assumptions: 5% cost of debt, 6% annual depreciation, 28.5% combined corporate income tax rate, 70% tax deferral.

In practice, a smaller shift in the equity/capitalization ratio than that shown here would be sufficient to maintain a utility's credit rating. Credit ratings reflect evaluation of all four metrics in tandem; a utility would significantly overshoot the mark were it to significantly improve three of the four while leaving the fourth unchanged.