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UTILITIES

OUTLOOK SNAPSHOTS

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2023 Sector Snapshot: US Utilities

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Executive Summary

- **We provide our Utilities sector strategy for 2023, including key themes, picks and pans and risks for the coming year.**
- **IG Power/Utilities (Market Perform). We are maintaining our Market Perform recommendation on U.S. utilities based on stable credit metrics and are comfortable reaching for the ~30 bps of yield pickup in the holdcos as long as the holdco is already mid-BBB and not high-BBB.** Holdcos make up one third of the utility index, while mostly A-rated opcos make up the remaining two-thirds. We still see risk of high-BBB holdcos following the peer group to mid-BBB in order to reduce equity dilution as the group funds another record year of capex, which EEI forecasts to be $155 bn this year. We are tracking the few instances of deferred fuel cost recovery (D, DUK, SO) but are confident in a full recovery.
- **HY Power/Utilities (Market Perform).** We are maintaining our Market Perform recommendation on HY Power/Utilities, which is a subsector made up of three incredibly distinct business models: a few rare utility holdco and intermediate cos, pure-play merchant power companies with significant commodity price exposure, and contracted renewables with no power price exposure. Merchant power companies Calpine (not covered since no access to financials), NRG Energy and Vistra Energy are the largest issuers in the sector and all are benefiting from natural gas prices at 12-14 yr highs. The contracted renewable names (NEP, CWEN) are some of the tightest bonds in overall HY.

Relative Value

US IG and HY vs. Utilities

	OAS			YTW			$ Price				YTD Returns	
	Current	YE 2021	Change	Current	YE 2021	Change	Current	YE 2021	Change	Duration	Excess	Total
US IG	142 bp	98 bp	44 bp	5.4%	2.4%	306 bp	$89.58	$109.14	-$19.57	6.9 yrs	-1.8%	-15.3%
US IG Utilities	**154 bp**	**117 bp**	**37 bp**	**5.5%**	**2.7%**	**279 bp**	**$88.30**	**$111.05**	**-$22.75**	**8.5 yrs**	**-1.7%**	**-17.7%**
Difference	12 bp	19 bp	-7 bp	7 bp	34 bp	-27 bp	-$1.28	$1.91	-$3.19	1.6 yrs	10 bp	-243 bp
US HY	455 bp	310 bp	145 bp	8.6%	4.3%	430 bp	$87.02	$103.31	-$16.29	4.1 yrs	-2.6%	-10.5%
US HY Utilities	**272 bp**	**277 bp**	**-5 bp**	**6.8%**	**4.1%**	**274 bp**	**$90.49**	**$102.41**	**-$11.91**	**4.4 yrs**	**0.9%**	**-8.0%**
Difference	-183 bp	-33 bp	-150 bp	-182 bp	-25 bp	-156 bp	$3.48	-$0.91	$4.38	0.3 yrs	350 bp	254 bp

Source: CreditSights, FactSet, ICE Data Indices, LLC

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US Utilities

Utilities

Executive Summary

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- IG Picks & Pans. Our Outperform rated names include PPL (conservative management team, strong balance sheet, recent asset sale proceeds), AEP and Duke (large-cap, multistate utilities both with pending contracted renewable sales to shore up balance sheets), DTE (favorable regulatory positioning in MI) and FirstEnergy. While FE is a consensus long on the street and bonds price in a return to IG, we see the actual S&P or Moody's upgrade and the new CEO as a catalyst for the bonds. Our Underperforms (NEE, BRKHEC) are based entirely on valuation.

- HY Picks & Pans. Our Outperforms for HY Utility/Power include Vistra Energy and Terraform Power but the sector is so defensive (see outperformance in table below) and spreads are so tight our O/Ps are mostly for carry at this point. VST is a large beneficiary of the run in gas prices and management has now locked in 70% of 2023-25 expected output at these higher prices.

- New issue outlook. We expect around $85 bn of new issue from utilities based on $35 bn of refis and revolver term outs and $50 bn of growth capex (detailed below). We do not expect any M&A issuance in 2023.

Key Themes for 2023

- Hands down the biggest theme in U.S. utilities is how utilities plan to fund both record capex and rising commodity prices (natural gas & power) without pushing utility bills too high. The 12 years of low and falling power prices (~half the bill) that allowed utilities to raise the T&D portion of the bills (other half of the bill) 10+% with a single digit overall rise in bills came to an end last year. This has resulted in increased bad debt expense and pressure from regulators to keep bills low. We expect utilities will successfully push through higher bills as the capex is integral to states' low carbon goals. The Inflation Reduction Act (IRA) will offset some of the bill increases, although not until 2023-24.

- We do not expect any large-cap utilities to fall to low-BBB at the parent for two reasons. On the quantitative front, moving from high- to mid-BBB only costs 10-20 bps but falling to low-BBB costs another 40-50 bps that no CFO wants to pay, especially in a rising rate environment. More importantly, on the qualitative front, owing to the agencies loose two-notch rule, if the holdco falls to low-BBB it puts the opco at risk of falling to high-BBB, which would alert regulators. No utility management team wants to have regulators poking around asking about credit ratings declining.

- How utilities incorporate significant tax credits from IRA will be a key theme for utilities in 2023 and the integrated utilities (which own generation) are in much better shape than the wires-only ones.

Top Risks for 2023

- Customer bill inflation leading to regulatory probes and political grandstanding has the potential for big headline risk. However, the biggest risk isn't lower ROEs that could impact credit quality. It is regulators trimming out year capex plans, which is an equity and EPS growth rate issue.

- Rising interest rates usually leads to yield generating equities, like utilities, to decline so a sharp rise in long-term interest rates could lead to an equity pullback that has management teams re-thinking their plan to issue equity.

- Rising interest rates could also bring down valuations for the utility opcos some utilities plan on selling to fulfill their equity issuance needs. PG&E (Pacific Generation) and FirstEnergy (FE Transmission) are the most impacted here.

Picks, Pans & Recommendations

Investment Grade Picks

- **Duke Energy** We like Duke's multistate (SC, NC, OH, IN, FL) service territory that minimizes regulatory risk, management's approach to NC decarbonization plans (let regulators pick the plan) and the pending contracted renewables sale at ~12x EBITDA. We expect a total sale value around $4.6 bn, which adjusted for $1.6 bn of project debt could lead to $3 bn of cash proceeds for DUK to help fund its $65 bn capital plan (2023-27 budget).

- **AEP**. Similar to Duke, we like AEP's multistate service territory (OH, TX, OK, AK, IN, MI, VA and WV) and contracted renewables sale, but we also like their new CEO (Julie Sloat) and history of protecting the balance sheet, including lower FFO/debt in 2019 but then raising it back up in 2021 (current guidance 14-15%, previous was 13-15%). We calculate their contracted renewables business is worth around $2.1 bn.

- **FirstEnergy**. FE is a consensus long among investors but with its holdco 2030s at +190 (dollar price adjusted) vs the mid-BBB peer group at +160, we do still see upside. We expect a move to full IG in 2023 and have confidence that the board really is targeting mid-BBB ratings. The next catalysts are a new CEO being appointed and S&P or Moody's moving to IG.

Investment Grade Pans

- **Berkshire Hathaway Energy** and **NextEra** are our Underperforms driven solely by tight bond spreads. We have a positive view on the management teams, balance sheets and asset bases of BRKHEC and NEE but so does everybody else. BRKHEC 2030s are 30 bps inside our high BBB/low A 8-10 yr peer average.

- We are maintaining our Underperform at **Avangrid** after downgrading in 1Q22 as we hold a cautious view on the company's pursuit into higher-risk offshore wind (AGR was just rejected by MA regulators to renegotiate one of its below-market PPAs) plus large non-utility exposure via the Renewables business (~15-20% post-PNM acquisition). AGR also has an elevated 5-year capex plan vs peers, but this is less of a concern now as we don't see either Moody's or S&P taking any further negative rating actions with AGR being mid-BBB and stable outlooks at both.

US IG Utilities Company Recommendations		
Outperform	**Market Perform**	**Underperform**
DUK	SO	BRKHEC
AEP	EXC	NEE
FE	ES	AGR
DTE	NI	
PPL	PEG	
ETR	CNP	
	D	
	XEL	
	WEC	
	EIX	
	AEE	

Source: CreditSights

High Yield Picks

- We have a favorable view on **Vistra Energy** owing to the company's long position in power generation combined with management locking in strong commodity prices during the 2022 surge in prices with 70% of 2023-25 now hedged at those levels. With 2029 spreads in-line with the BB index around +290 we see VST in better shape than the index with strong free cash flows ($2+ bn annually) and catalysts coming from a 3rd party investor in clean energy Vistra Zero.

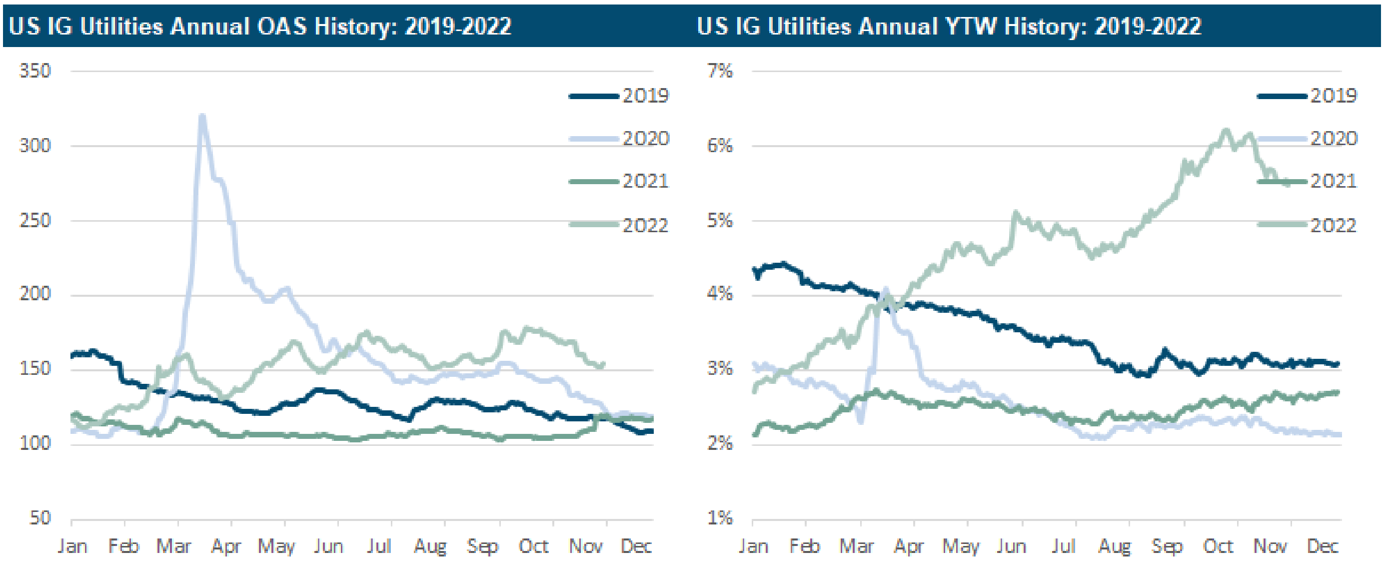
- We are maintaining our Outperform on **Terraform Power** but the bonds have had a strong run since the initial buyout when Brookfield took leverage to 9x and spreads gapped out. Consolidated leverage is down to the mid 6x range and the 2028s are now 30 bps inside the BB index (+260 vs +290). We like the contracted nature of the cash flows with a weighted average contract life beyond the last parent bond maturity and amortizing project debt (2/3 of total debt is project debt).

High Yield Pans

- We do not have any HY power/utility pans at this time.

Relative Value

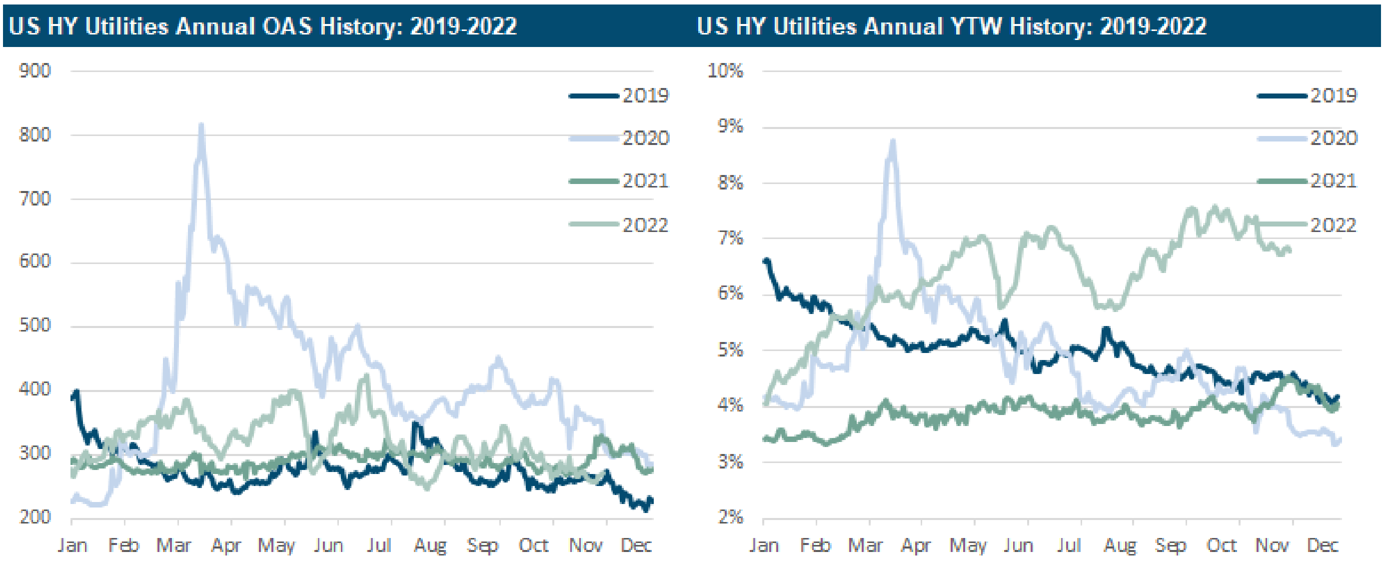
Investment Grade



Source: CreditSights, FactSet, ICE Data Indices, LLC

Utilities are an obviously defensive sector and investors need to keep in mind that upon emerging from bankruptcy in July 2020, around $30 bn of low-BBB PacGas bonds entered the now $500 bn utility index and this had the impact of widening the index by 10-15 bps owing to very wide PacGas bond spreads. In other words, the utility index spread, ex-PacGas is actually 10 bps tighter. The biggest driver of valuations is FFO/debt targets and thus ratings stability and regulatory relationships but **deferred fuel costs** could start to creep up in 2023. Contrary to some investor's initial thoughts, ESG issues and coal ownership is not a driver of sector spreads. We view the generous (~$1 tn over ten years) tax credits from the Inflation Reduction Act as a nice tailwind for the sector but those won't materialize until 2023-24 and beyond.

High Yield



Source: CreditSights, FactSet, ICE Data Indices, LLC

Similar to IG utilities, HY power is a very defensive sector since there is no exposure to slowing consumer spending or recession fears and inflation, as it relates to commodity prices, is a big positive for the group. This dynamic has led to tight bond spreads and sector outperformance in 2022, but with currently tight spreads we are hard-pressed to see additional outperformance in 2023 unless the economy heads towards a hard-landing. For the independent power producers (IPPs), aka merchant power companies, like Calpine and Vistra, natural gas prices are the biggest driver of power prices and thus EBITDA margins. NRG is short power and charting NRG and VST bond spreads vs. forward natural gas prices shows NRG outperforms when prices are falling and vice versa for VST. We strongly prefer VST owing to strong asset coverage from actual assets, not an asset-lite retail book like NRG.

Fundamental Outlook

IG Utilities Largest Issuer Fundamental Snapshot

	Total	FFO / Debt			
Issuer	Outstanding ($B)	Current	YE 2021	YTD Change	FY2023 Leverage Direction
Duke Energy	$68.0	14%	14%	0%	Flat
Southern	$55.0	11%	13%	-2%	Flat
PG&E	$51.0	14%	13%	1%	Flat
Exelon	$38.0	18%	19%	-1%	Higher
AEP	$37.0	17%	12%	5%	Flat
Edison	$30.0	11%	12%	-1%	Flat
Fortis	$29.0	12%	12%	0%	Flat
Entergy	$28.0	12%	9%	3%	Flat
ConEd	$25.0	17%	16%	1%	Flat
Xcel	$24.0	16%	16%	0%	Flat

Source: CreditSights, FactSet, ICE Data Indices, LLC, Company Filings

HY Utilities Largest Issuer Fundamental Snapshot					
	Total		Net Leverage		
Issuer	Outstanding ($B)	Current	YE 2021	YTD Change	FY2023 Leverage Direction
Vistra	$13.7	4.0x	6.1x	-2.1x	Lower
Calpine (pvt financials)	$11.0	~4.5x	~4.5x		Flat
NRG Energy	$8.0	4.6x	3.4x	1.2x	Lower
Clearway	$7.0	5.9x	6.7x	-0.8x	Flat
Terraform Power	$6.5	6.4x	7.6x	-1.2x	Flat
NextEra Energy Partners	$4.8	3.0x	3.9x	-0.9x	Flat
FirstEnergy (util holdco, FFO)	$20.7	10.6%	9.3%	1.3%	Lower

Source: CreditSights, FactSet, ICE Data Indices, LLC, Company Filings

We expect stable credit metrics for the utility sector. Four (AEP, CNP, XEL and NI) of the last five FFO/debt guidance changes have all been positive (Underperform rated AGR slightly lowered theirs), albeit tiny ones so the long-term trend of declining FFO/debt has not only stabilized but has reversed.

Primary Market Outlook

IG Utilities 2023 Primary Market Expectations				
Issuer	Rating	Est. Amount ($B)	Use of Proceeds	Anticipated Timing
ES (CL&P)	A1/A+/A+	$0.4	Refi	1Q23
BRKHEC	A3/A-/NR	$0.9	Refi	1Q/4Q23
NEE	Baa1/BBB+/A-	$2.0	Refi	1Q23
CNP (CERC)	A3/BBB+/A-	$0.7	Refi	1Q23
ATO	A1/A-/NR	$1.1	Refi	1Q23
OGS	A3/A-/NR	$0.3	Refi	1Q23
DUK Carolinas	Aa3/A/NR	$1.0	Refi	1Q23
EVRG (EVRG Metro)	A2/A+/NR	$0.3	Refi	1Q23
D (opco)	A2/BBB+/A	$0.7	Refi	1Q23
EIX	Baa3/BBB-/BBB-	$0.4	Refi	1Q23
EIX (opco)	A3/A-/BBB+	$1.7	Refi	2Q/3Q/4Q23
ES	Baa1/BBB+/BBB+	$0.9	Refi	2Q/4Q23
XEL (N. States Pwr)	Aa3/A/A+	$0.4	Refi	2Q23
PEG (opco)	A1/A/A	$0.8	Refi	2Q/3Q23
NEE (opco)	Aa2/A+/AA-	$0.5	Refi	2Q23
BRKHEC (PacifiCorp)	A1/A+/NR	$0.3	Refi	2Q23
CMS (opco)	A1/A/A+	$0.6	Refi	2Q/3Q23
PCG (opco)	Baa3/BBB-/BBB-	$2.1	Refi	2Q/3Q23
SO	Baa2/BBB/BBB+	$1.3	Refi	3Q23
EXC (BG&E)	A3/A/A	$0.3	Refi	3Q23
SO (Ga Pwr)	Baa1/BBB+/BBB+	$0.7	Refi	3Q23
ETR (ETR LA)	A2/A/A	$1.4	Refi	3Q23
DUK Ohio	Aa3/A/NR	$0.3	Refi	3Q23
DUK Progress	A2/A/NR	$0.3	Refi	3Q23
SRE (SDG&E)	A1/A/A	$0.5	Refi	3Q23
WEC	Baa1/BBB+/BBB+	$0.7	Refi	3Q23
SO (Southern Co Gas)	Baa1/BBB+/BBB+	$0.4	Refi	4Q23
XEL	Baa1/BBB+/BBB+	$0.5	Refi	4Q23
DUK	Baa2/BBB/BBB	$0.4	Refi	4Q23
AEP	Baa2/BBB+/BBB	$0.5	Refi	4Q23
ES (PSNH)	A1/A+/A+	$0.3	Refi	4Q23
PEG	Baa2/BBB	$0.8	Refi	4Q23
EXC (Delmarva Pwr)	A2/A/A	$0.5	Refi	4Q23
ED	Baa2/BBB+/BBB+	$0.7	Refi	4Q23
SO (Alabama Pwr)	A1/A-/A+	$0.3	Refi	4Q23

We expect $85 bn of new supply in 2023 broken down as follows: $25 bn of maturities, $10 bn of revolvers being termed out, $50 bn of growth capex and no M&A driven issuance. Our growth capex figure starts with the $150 bn of sector capex and assumes the 57% average capex funding from retained cash flows holds into 2023. Of the remaining 43%, we assume 10% is funded with equity/asset sales leaving 33%, or $50 bn, to be funded in the bond market (holdco and opcos).

We expect minimal new supply in the HY Power sector as the group did a great job of pushing out maturities in 2020-21 and there are no large maturities for the group in 2023.

Event Risk/M&A Landscape

We do not expect any significant M&A in IG utilities as capex is at an all-time high ($155 bn in 2022, per EEI) and it is much cheaper to build at 1x rate-base and trade at 2+x rate-base then bid a 10-20% premium on top of the group's ~19x PE ratio. We expect continued monetizations of minority interests in utility opcos such as PG&E's plan to sell 49% of Pacific Generation and FE's plan to sell another 20-30% in FirstEnergy Solutions. However, the buyers here are infrastructure funds and not other utilities that issue utility index debt to fund the purchases. Event risk is limited to fire season (July-November) for California utilities (PCG, EIX, SRE) and we note if one company exhausts the $18 bn AB 1054 wildfire fund, the agencies are likely to downgrade all three names.

In HY, there is a small chance VST moves the nuclear plant to VST Zero and places new subordinating debt at that subsidiary, but overall buyout risk is low since the **TRA would kick in** and add half a turn to the EV/EBITDA multiple.

ESG Considerations

We expect the primary ESG investor considerations for utilities to be largely unchanged as we progress through next year, with the heaviest focus remaining on the 'Environmental' component and more specifically on coal generation exposure. However, we would not be surprised and actually expect to see additional accelerated coal plant retirement announcements in light of the IRA, and we already saw two major coal-heavy utilities make these announcements shortly after the bill had passed in August (see **Xcel Energy: Targeting Zero Coal by 2030** and **DTE Energy: Accelerating Zero-Coal Plan by 5 Years**).

The IRA is a clear ESG positive for the utilities sector which aside from the enhanced support for traditional renewable investments (wind/solar tax credit extensions, plus opportunities for adders) also includes incentives for other ESG-friendly projects like green hydrogen ($3/kg tax credit), nuclear power (nuke PTC essentially sets a $44/MWh floor price), battery storage (new 30% ITC) and other clean energy technologies (i.e. EVs). The IRA also adds a slight boost to the 'Social' component of ESG in our view, as the significant tax credits will go a long way to offset additional customer bill inflation, and the headline number of $380 billion for IRA costs is now speculated to cost closer to $1 trillion. See **Clean Energy: Workflow Tracking File For Clients** and **Clean Energy: Inflation Bill Follow-up/Questions** for more on the IRA.

AUTHORS

Winnie Cisar
Global Head of Strategy

Andrew DeVries, CFA
Co-Head of U.S. Investment Grade Credit / Senior Analyst - Utilities and HY Power

Zachary Griffiths, CFA
Senior Analyst - U.S. Strategy

Brian Perez
Analyst – Strategy

Nick Moglia, CFA
Analyst – US Refiners and Utilities

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