

# The Impact of Credit Market Turbulence on Utility Operations and Financing

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# Credit Challenges Abound

- As has been widely reported, the market for credit has become difficult, and in some cases impossible.
- The news has focused on homeowners with adjustable mortgages in the face of declining real estate values.
- The news has also focused on highly profitable corporations unable to borrow to meet payrolls and ordinary operating expenses.

# Utilities Face Them Too

- Classic flight to quality.
- Risk premiums for all utility bonds have risen dramatically, especially for lower rated bonds.
- Interest rates for BBB-rated long term debt of 10%--a whopping 600 basis points over US treasuries.
- Financings now take days, instead of hours.

# Short-Term Credit Needs

- Transmission and spot energy supplies from RTOs.
- Purchased power/gas.
- Operating expenditures.
- Payroll.
- Equipment expenditures.

# Short-term Credit Options

- Utilities with credit ratings below investment grade rely on credit agreements with groups of banks and investment houses.
- Utilities with better credit have more options.
- Longstanding credit suppliers' ability to lend is limited.
- For 11 days in September, no credit was available at any price.
- Utilities wonder: should they hoard cash?

# 2007 Electric Market Difficulties

- 10-year rate freeze ended January 1, 2007.
- Many ratepayers witness dramatic increases.
- General Assembly mandated change:
  - New Illinois Power Agency replaced power procurement auction.
  - Ratepayer refunds.
  - Some rates restructured.
  - Other market reforms.

# Ratepayer Difficulties ...

- Higher unemployment
- Higher food prices
- Higher mortgage payments
- Reduced home values
- Overextended credit-card debt
- Reduced value of retirement portfolios and asset values
- Volatile energy prices

## ... Lead To Unpaid Utility Bills

- In Illinois, economic turbulence in 2008 followed electricity turbulence in 2007.
- Customers unable to pay after the rate freeze ended in 2007 are now faced with insurmountable utility balances in 2008.
- Utility exposure to bad debt expense is increasing.



# No Service Territory Growth

- Downsizing of commercial and industrial customers.
- Long planned real estate developments are being abandoned, even though utility infrastructure has already been built.
- Utilities face stranded investment.

# Silver Linings

- Energy costs have fallen dramatically.
  - Natural gas prices have fallen over 50% from peak in June/July 2008.
  - Prices for gasoline and home heating oil have also fallen, easing ratepayer budgets.
- Ratings agencies have upgraded several Illinois utilities to investment grade.
- Reduced economic activity should delay the need for investment in new plants and facilities.

# Effect On New Construction

- Who knows?
- Lots of competing considerations out there:
  - Carbon regulation
  - RTO capacity markets
  - Demand for wind and other renewables
  - Reduced energy demand
  - Volatile natural gas prices
  - Construction costs

# Aging Electric Infrastructure

- 1950's era electric distribution technology unsuitable for modern competitive markets.
  - Limited ability to apply modern energy management tools.
  - No incentive for end-users to respond to real-time spot energy prices.
  - Incorrect price signals for distributed generation.
  - No automatic communication of local outages.
  - Manual meter reading.

# Aging Gas Infrastructure

- Local natural gas distribution pipes are reaching the end of their useful lives.
- LDCs are limited in the gas pressure they can apply.
- Heightened concerns over safety and reliability.

# Renewable Portfolio Standard

- 25% RPS in Illinois by 2025.
- 75% to be from wind, with a preference for wind in Illinois and neighboring states.
- RPS requirements are forgiven if they would raise energy prices by more than .5% in 2008, escalating to 2.015% in 2011.



# Need For Renewables

- Nationally, there is a mismatch between wind supplies in the US and location of electricity demand.
- Using substantially more wind power will require substantially more transmission.

# Real Investment Needs

- While the current economic slowdown will impact energy demand, utilities still have significant investment needs.
- Working credit markets will be vital to undertake infrastructure enhancements and modernization.



# Challenge To Regulators

- Utility rates must be set at the lowest reasonable cost, but cannot be so low as to confiscate utility assets.
- The consequences of getting it wrong are far greater than usual:
  - Too high, and already burdened ratepayers cannot afford to pay.
  - Too low, and utility credit ratings tank, reducing the availability of credit and increasing the cost.

# Illinois Challenges

- Every major energy and water utility in Illinois filed a rate case within the past two years.
- The proposed cost of capital in all of these cases reflect credit market conditions prior to the current credit market crisis.
- It remains to be seen if the utilities are able to withstand the new credit realities without filing new rate cases.